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Real estate has, and will always be, a prized possession. And the ability to buy and sell real estate at will is part of the American Dream. Because real estate is a key indicator of our economy, and because most people view purchasing real estate among the biggest decisions in their lives, it is no wonder quality real estate professionals are in high demand.

A primary goal of real estate education is to prepare students to enter the professional world armed with the knowledge they need to be ethical, professional, and, of course, successful. This textbook was written with that goal in mind, as well as the challenge of preparing you to pass your state real estate licensing exam. *Real Estate Principles and Practices* is a thorough treatment of the national topics prospective real estate licensees must understand. The text covers the fundamentals of the real estate profession, and introduces you to everything from real property and contract law to real estate financing and appraisal, commercial real estate to property management, fair housing to ethics.

The authoring and review team for *Real Estate Principles and Practices* consists of veteran instructors and real estate professionals, as well as subject and industry subject matter experts. This text was written with the understanding that every student brings a different level of experience and learning style to the classroom. That is why the text is easy to use and easy to understand.

**Using This Text**

Whether used in the classroom or for self-study, you will find the information presented in a clear and concise manner. Key terms, case examples, challenge activities, chapter summaries, and chapter quizzes reinforce the concepts presented throughout each chapter. The included glossary, math review section, and practice exam provide additional tools to help you master critical concepts. Once you have completed your prelicensing course work, keep this book handy as a valuable reference tool as you pursue your new real estate career.

**ACKNOWLEDGMENTS**

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Now that you’ve decided on a career in real estate, let’s begin by talking about becoming a real estate professional and about the industry in general. This chapter introduces some of the many careers available in the field of real estate, focusing on real estate sales, its advantages and disadvantages, some areas of specialization, and things to consider when choosing a broker. Then, to understand real estate as a profession, it’s important to know how the real estate industry functions as a whole.

After reading this chapter, you will be able to:
• Identify careers and specializations in real estate.
• Contrast independent contractors and employees.
• Identify the physical, economic, governmental, and social factors impacting real estate.
• Describe the economic markets and influences on real estate.

Key Terms
Broker
Broker-Dealer
Brokerage
Buyer’s Market
Cost of Money
Economic Base
Errors and Omissions Insurance (E&O)
Independent Contractor
Inflation
Licensee
Non-homogeneity
Real Estate Cycles
REALTOR®
Salesperson
Scarcity
Seller’s Market
Statutory Nonemployee
Supply and Demand
Careers in Real Estate

Whether you choose to go into real estate sales or another real estate-related career, you will find that the knowledge and insight you gain from studying for and obtaining a real estate license is worth the effort. Real estate is one of the few careers where pure ability is all that matters. Many brokers use performance as their only employment test and rate desire as their most important criterion. Your age, race, gender, and physical ability are not important. If you are good with people and perform well, then you are a coveted individual in an industry where performance and personal service go hand in hand.

The Real Estate Broker

A real estate brokerage serves as an intermediary between buyers and sellers and/or lessees and lessors of real estate, finding buyers for sellers, tenants for landlords, and properties for buyers and tenants. A real estate broker is generally defined as one who is licensed to represent another person in a real estate transaction with the intent to receive compensation or valuable consideration. More specifically, a real estate broker is a licensed person or legal business entity who, for a fee:

- Sells
- Lists
- Leases
- Exchanges
- Negotiates
- Otherwise deals in the real estate of others

In some states, an individual who fulfills the role of a broker is licensed as and/or referred to as an “employing broker,” a “sponsoring broker,” a “managing broker,” a “principal broker,” “broker-in-charge,” or similar designation.

The Real Estate Salesperson

Generically speaking, a real estate salesperson is an individual licensee associated with a broker who may perform most of the acts of a broker. However, a real estate sales associate may not work independently of his or her licensed broker and, in fact, can function only through the broker with whom he or she is associated. Everything must be done with the consent of the broker.

The salesperson cannot independently enter into listing agreements or other contracts to represent people. Furthermore, a salesperson cannot independently conclude a sale, receive a commission, or advertise. All of these actions must be done in the name of the broker.

Depending on state law, an individual who is an associate in a brokerage firm may be licensed as a “salesperson,” a “sales associate,” an “associate broker,” or even a “broker.” You may also see the terms “agent” or “licensee” used to refer generically to someone who has a real estate license.
Real Estate-Related Fields

When most people think of the real estate profession, they tend to think of brokers or salespersons. Although these careers have the highest visibility, there are many opportunities for real estate licensees to move into other related fields. While a license is not required for all of these careers, the most lucrative ones do require a real estate license. Even if not required, a real estate license or real estate associate degree is an asset that shows potential employers you understand real estate licensing laws and how they affect real estate business.

Real Estate Finance

Real estate finance provides excellent employment opportunities, particularly for those who are good with numbers and with people. Institutions such as savings and loan associations and commercial banks have a need for highly trained people to fill real estate-related positions. In addition to taking and approving mortgage loan applications, these professionals can manage loan portfolios, appraise properties, and assess risk. There are also opportunities in banks for people with title experience and for people familiar with the national secondary mortgage markets.

Mortgage companies are also looking for people who have many of these same skills. Mortgage brokers, real estate investment trusts, endowments, private lenders, and government agencies devoted to real estate finance (such as the Federal Housing Administration and the U.S. Department of Veterans Affairs, which we’ll look at in detail later) offer additional opportunities for interesting careers that involve real estate and finance.

Real Estate Appraisal

Real estate appraisers can work for financial institutions, developers, property managers, or government agencies. Many experienced appraisers work for themselves by bidding on independent appraisals for these employers or private investors.

An appraiser must have a thorough understanding of real estate and of the appraisal methods. Eventually, experience becomes the appraiser’s best asset. By working for an employer first, you can gain this experience working with experienced appraisers. After amassing sufficient capital, competence, experience, and contacts, you should be ready to go out on your own as a fee appraiser. At this stage, you’ll know how to value properties and your services.

Most states require a separate license as a real estate appraiser to work in this field. You should inquire about the pre-licensing requirements in your state if you decide you want to become a licensed or certified appraiser.

Real Estate Property Management

A property management company has an agency relationship with the property owner, and owes the owner the same fiduciary duties of obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care they provide to all clients. A property manager or property management company is a general agent because of the broad range of duties they must perform.
The property management relationship begins with a management agreement. This agreement details the duties and responsibilities of each party as well as the compensation. Typically, the property manager is responsible for collecting rents, selecting tenants, renting and leasing units, maintaining and repairing the building, supervising all building personnel, managing tenant relations, and accounting for all income and expenditures.

Accounting for all income and expenditures is more involved than it sounds. The property manager is responsible for setting rents that cover all expenses associated with operating the building and still return a profit. The property manager must also develop and maintain a plan for the maintenance and rehabilitation of the building so that it produces the greatest amount of rental income for as long as possible. Furthermore, the property manager must be skilled at risk management to protect the building from loss and insulate the owner from liability.

**Real Estate Property Development**

Property development is the process of acquiring large tracts of land at a low cost per acre, then subdividing and improving it with streets, sewers, and utilities so it can be resold at a higher cost per front foot (for lots) or per square foot (for buildings). Land can be developed for residential, commercial, industrial, or other uses. Once the appropriate amenities—such as streets, water, and utilities—are in place and necessary zoning obtained, lots can be sold as bare land ready for a structure to be built on it or with houses or buildings already in place. Most residential developments have houses built on them or vacant lots on which a buyer can choose to have a particular style of home built by the developer.

Typically, residential developers take the following steps:

- Make a feasibility study of the prospective development
- Execute an option or purchase agreement for a large tract of land
- Obtain any necessary zoning changes
- Obtain early financing from financial institutions or investors
- Install improvements, such as streets, sewer, water, electricity, gas lines, etc.
- Arrange for parks, playgrounds, golf course, swimming pool, etc.
- Take care of legal arrangements, such as deeds and title evidence for each lot
- Market and sell the individual lots
- Construct buildings

**Real Estate Property Construction**

Real estate careers in construction are often entered through the real estate brokerage side of the business by selling homes or other buildings. Homes are built either with a contract for clients who specify the type of structure and features they want or on speculation (“spec”) where a buyer is found for a home after it’s completed. Builders can work as developers or with specific development companies.

In addition to sales help, companies that specialize in construction also have a need for appraisers, property managers, and finance professionals. People with a finance and real estate background can be especially beneficial to builders because construction often involves large-scale financing and an ongoing need to monitor costs and profits.
Real Estate Title Work
More and more brokers, banks, and lawyers are getting into this service area as profit margins are shrinking elsewhere. New regulations are making it easier for companies to provide homebuyers with more than one service with proper disclosure.

Title work is a natural extension of other real estate businesses, so there are many career opportunities available, such as title researcher, escrow agent, and title insurance overseer. In fact, a person working for a title company may be asked to do more than one of these tasks.

Real Estate Trade Association Work
There are numerous national, state, and local trade associations that offer career opportunities related to the real estate field. Staff positions usually offer day-to-day support to the mostly volunteer officer positions. The duties of the staff include education, lobbying, public relations, and member services. Additional positions may include computer work or work on one of the many publications and journals published by these organizations.

Real Estate Education
The license law of most states dictates specific educational and continuing education requirements, providing ample opportunities for interested persons to get involved in real estate education. Qualified practitioners are in constant demand for teaching these courses.

Real Estate-Related Government Work
Real estate-related careers are available at all levels of government. At the federal level, agencies involved with real estate include the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), the Federal National Mortgage Association (Fannie Mae), and the U.S. Department of Housing and Urban Development, to name a few. There are literally hundreds more with some connection to real estate—from the General Services Administration, which is a property management agency, to most branches of the military, such as the Army Corps of Engineers.

At the state and local level, you are likely to find numerous agencies that benefit from people with knowledge of real estate laws and procedures. For example, on the local level, departments of taxation and zoning are two prominent agencies that are related to real estate. Another area that’s thriving is urban planning, which is concerned with the orderly growth and development of a city.

Selling Securities
Every state has securities laws, sometimes called “blue sky laws,” that a registered securities broker-dealer license to sell any type of investment opportunity or security, such as registered stocks and bonds or unregistered securities such as mortgages or land contracts. A typical real estate transaction in which the real estate licensee assists a buyer in locating available financing does not require a securities license.

Anyone who brokers or sells mortgages or land contracts as investments, on the other hand, is acting as a “broker-dealer” within the definition of the securities laws and must be registered as such. A real estate license does not allow someone to sell any type of securities.
A Real Estate Sales Career

Most people starting out in real estate go into sales, but the decision does not end there. There are many specializations in real estate sales. For the most part, the law is applied uniformly to all types of real estate. The main obstacles in moving from one specialization to another are learning the special terminology for a specific area of real estate and finding a broker who is willing to act as a mentor on the technical knowledge needed to be competent and successful in a highly specialized area.

Residential Properties

Residential sales can provide a rewarding career for new or experienced real estate professionals. The process begins when someone wants to sell their home or when someone is looking for a home. After obtaining a listing agreement from a seller, an agent assists in determining the appropriate asking price for the home and then begin searching for ready, willing, and able buyers for the listed property. An agent who represents the buyer through a buyer agency agreement assists the buyer in defining requirements and finding houses that meet those requirements.

Real estate sales professionals utilize various forms of advertising, information sharing, and people skills to find the right buyer or the right house. The agents work with their seller or buyer clients throughout the entire process, assisting them with developing, communicating, and presenting offers and counteroffers. Finally, the agents are on hand to assist in fulfilling the terms of any contracts.

Many licensees concentrate on one type or style of property or one particular neighborhood, a practice called farming. Finding and specializing in a particular neighborhood or type of property is considered to be one of the best ways to succeed in residential sales. Residential properties include the following:

SINGLE-FAMILY RESIDENTIAL PROPERTIES The majority of new licensees begin their work in the single-family residential market. Buying and selling single-family homes is the typical entry-level position in real estate. Most brokers recruit salespersons to work in this area since there are more single-family homes than any other type of property. From the perspective of new licensees, beginning in single-family homes is a logical choice since they probably know at least a few people who may be in the market for a house. Furthermore, many people may have some familiarity with this area of real estate through personal experience. Finally, there’s less technical knowledge required to become competent in this area.

MULTI-FAMILY RESIDENTIAL PROPERTIES Multi-family residential properties can be anything from a simple twin-single (or double or duplex) to a large apartment building. The typical buyer in this category is an investor rather than a homebuyer. Much more technical knowledge about return on investment, occupancy rates, maintenance, and other topics relevant to investment properties is required and expected from this group of buyers.

CONDOMINIUMS A condominium is a form of joint ownership where the condominium owners own the airspace within their specific units and use of the common elements in the condominium complex, such as streets, swimming pools, etc. Condominium associations enforce the bylaws of the development, assess fees, and arrange for the maintenance of the common areas. Condominiums can be commercial, retail, or even recreational.
COOPERATIVES A cooperative, sometimes referred to as a co-op, is a building that is owned by a nonprofit corporation formed for that purpose. Co-op residents (cooperators) are shareholders who have a proprietary lease for a specific unit in the building and the right to use the common elements of the building. Cooperators generally have the ability to vote whether or not to allow a particular person to buy into the cooperative, as long as there are no violations of fair housing laws.

Specialized Residential Properties

The housing market today is broader and more diverse than in past years. The trend toward alternatives to traditional single-family homes opens additional opportunities for specialization. Here are a few alternatives:

- **Converted-use properties** are existing buildings—such as factories, warehouses, office buildings, churches, and schools—that are converted for residential purposes rather than being destroyed.

- **Manufactured housing** is a growing market in many areas. These homes are constructed in the same manner as trailers or mobile homes, as opposed to conventional on-site construction. They are usually attached to foundations and considered to be permanent structures, as opposed to mobile homes.

- A **timeshare** is a purchase of an ownership interest in a property (often in a resort area condominium) for a fixed or variable time period. For example, 52 different purchasers buy one condominium; each agrees to possession for one week per year. Taxes, insurance, maintenance, and other costs are shared equally.

Other Property Types

While residential property sales offer many areas of specialization, many real estate licensees find success working with commercial, industrial, or farm properties or vacant land.

- **Commercial properties** include offices, stores, hotels, and other buildings. Those dealing in commercial properties are usually involved not only in sales and other aspects of brokerage, but also in leasing and leasebacks, property management, and even construction or financing.

- **Industrial properties** include land and structures involved in the production, distribution, and storage of tangible economic goods. The knowledge and skills needed for industrial real estate overlap with commercial real estate. Typically, a person specializes in commercial and industrial properties because there’s less demand for only industrial services, and a high level of experience and expertise is required.

- Specialization in **farm properties** has been declining due to the widespread sale of farmland for other uses and the decreasing number of family-run farms. Some licensees, however, specialize in **vacant land** sales, working with investors, developers, municipalities, and the buying public. There are many things to consider when analyzing the value of a parcel of vacant land. As with most categories of real estate, location is usually the first item on the list of considerations with regard to what can be done with the property. Additionally, there is a long list of site considerations to address before determining how—and if—land can be subdivided and developed.
This may include zoning and the characteristics of the land itself, such as water issues, as well as the environmental impact of development. A licensee who practices in this specialty must be well versed in the laws that govern subdivided land. It also helps to understand how a community is growing.

<table>
<thead>
<tr>
<th>Advantages to Real Estate Sales</th>
<th>Disadvantages to Real Estate Sales</th>
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<tbody>
<tr>
<td>• Compensation is based on commissions, so earnings are only limited by your knowledge, experience, desire, activity, and hard work.</td>
<td>• Since compensation is based on commissions, your income may not be steady, especially in the early stages of your career.</td>
</tr>
<tr>
<td>• You control your time. Work as much or as little as you like to reach your goals.</td>
<td>• Real estate sales are affected by seasonal and cyclical swings.</td>
</tr>
<tr>
<td>• Office time is kept to a minimum, as contact with people is the primary means of soliciting listings, showing properties, and making sales.</td>
<td>• Most successful people in real estate need to work at least some evenings and weekends.</td>
</tr>
<tr>
<td>• Owning your own brokerage is possible.</td>
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</tbody>
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Choosing a Broker With Whom to Associate

Regardless of the area in which you may want to specialize, you must select a broker with whom you’ll work. This is one of the most important decisions that you’ll have to make after deciding on a real estate career. There are many issues you should consider when choosing a broker. You will want to listen carefully and ask questions as you meet with prospective brokers.

Level of Training

The amount and quality of training offered by brokers vary greatly. Many large brokerages have standardized training programs that all new licensees must complete. These training sessions cover a broad range of topics including how to sell yourself and how to sell your company to prospective clients. This can be very helpful in attracting new listings. Some brokers assign you phone time or even assign you a mentor to walk you through some of the processes and procedures.

Many smaller brokerages do not have formal training programs, but they still offer assistance. This type of arrangement usually gives you direct contact with your broker, allowing you to benefit directly from his or her experience. You need to know which level of training you are most comfortable with and which best suits your individual needs.

Brokerage Services

Brokers usually offer administrative support and tools to help you do your job effectively and efficiently. These brokerage services may include websites, email services, Internet connections, voice mail, electronic networking, online forms and software tools, and other means of electronic communication to keep you connected to your brokerage and to your clients. Brokerages may also provide radio, television, and magazine advertising for you and your listings.

Many brokerages supply these things to you as part of your agreement with them; some charge a nominal fee; still others require you to provide these things at your own expense.
**Compensation**

Real estate brokers are usually entitled to *compensation* for performing the professional services specified in their *contracts* with buyers and sellers. Sales associates may only be compensated by their broker, never by a member of the public.

Brokerages use different methods to handle compensation. Some firms split the compensation with you 50%-50% or 40%-60% (40% goes to you, 60% goes to the brokerage). Other firms give you a higher percentage, such as 80%-20% or 90%-10%. In these arrangements, you are more likely to pay your own costs for things like support, business cards, and signs. If you receive 100% compensation, you will likely pay the brokerage a monthly fee for using its name, service, and facilities, whether you make a sale or not.

There are pros and cons to these methods of compensation, and there are some places that offer choices in the middle. A larger commission split may sound good, but paying for everything can add up. Plus, the larger commission split doesn't matter if you can't make sales because you don't have the necessary tools or the proper training.

On the other hand, if you have access to services, a sales background, or experience in some area of real estate, this may influence your choice of a brokerage. Some licensees like the image, prestige, and contacts they get by being associated with a large firm. Others like the opportunity to work with customers in a niche market, which smaller brokerages specialize in. Only you can decide what's right for you.

**Broker-Licensee Relationship**

Some important points of the broker-licensee relationship can be defined by the type and size of brokerage. Such points may include but are not limited to designated phone time, customer referral policy, and chain of command.

Another critical decision is the *employment relationship* you have with your broker, where you decide whether to work as an independent contractor or an employee.

According to *common law*:

- **Independent contractors** typically control the means and methods of accomplishing an assigned task; the broker has the right only to demand the end result. An independent contractor is responsible for his actions to the person or organization who contracted with him, and for his own tax liability to the Internal Revenue Service, as well as other taxation agencies.

- **An employee** is a person whose results are mandated by the employer and the employer controls how the results are accomplished. The employer is responsible for withholding income tax as well as Social Security, unemployment, and Medicare. The licensee’s income is subject to earnings withholdings, resulting in a W-2 form to the licensee at the end of the year.
Real Estate Employees

Very few real estate licensees, particularly those involved in residential sales, are employees. It’s much more common for a real estate licensee to be an independent contractor. There are, however, a few specialized areas where licensees might be employees:

- In commercial real estate, where it might take several years for a large transaction to close. As an employee, licensees may receive a small salary in addition to the commissions earned on their sales.
- A licensee who manages property for a property management firm or property owner.
- A licensee who works for a developer/builder.

Statutory Nonemployees

Because real estate license law in most states requires brokers to supervise the activities of associated licensees, the Internal Revenue Service created the category of statutory nonemployee, under which someone is treated as an independent contractor for all tax purposes if these conditions are met:

- The individual is properly licensed.
- All payments for services as a direct seller or real estate agent are directly related to sales or other output, rather than to the number of hours worked.
- The licensee performs services under a written contract providing this person will not be treated as an employee for federal tax purposes.

Supervision versus Control

While brokers are required to supervise licensee activities, they do not have specific control over the details of those activities. For example, a broker cannot require an independent contractor to be in the office from 9 to 5 every day. In other words, the broker can tell the licensee what to do, but not how or when to do it.

The broker is responsible for ensuring that licensees stay informed. While office sales meetings and training events help licensees stay current with industry news and keep skills sharp, the measure is generally weighed in context with the licensee’s competence, skill, and level of production, rather than meetings and events attended.

The laws and regulations concerning broker control and supervision are stricter in some states than in others. For example, in some states, brokers are allowed to require that licensees attend specific meetings or educational offerings.

Tax Considerations

At the end of the tax year, an independent contractor receives a 1099-MISC form detailing any commission-based income, not a W-2. Remember that a broker is not required to pay into Social Security or unemployment for commission that is paid to independent contractors. Instead, independent contractors are responsible for paying their own Social Security as though they were self-employed. Independent contractors are also responsible for sending quarterly payments to the IRS to meet their tax obligations.
For Example

A licensee might receive a W-2, however, for nonproduction income. Let’s say licensee M does an excellent job getting listings and is the top salesperson at ABC Realty. The broker asks M to provide a quarterly sales training session for new agents. M is paid $100 an hour. That would be considered W-2 income because the training sessions do not generate commission. As long as his commission incomes from sales are more than 90% of his total income, he is an independent contractor according to the IRS.

Consequences of Not Meeting Requirements

Independent contractors must ensure they meet the legal criteria for claiming independent contractor status and should consult with a trusted tax advisor, accountant, or attorney to be certain. Simply claiming such status, filing the proper tax forms, and waiving rights as an employee may not qualify someone as an independent contractor under the law. If the qualifications of the independent contractor relationship are not met, either party may be liable for additional consequences. The broker may be liable to pay:

- Unemployment insurance premiums (state and federal),
- Workers Compensation premiums
- Social Security taxes
- Medicare taxes
- State and federal withholdings
- Interest and penalties on the amounts not paid

Independent Contractor Agreement

Both parties should sign an independent contractor agreement that spells out the specifics of the broker-licensee relationship. While some states have laws or regulations requiring specific information that must be included in an independent contractor agreement, most agreements address the following topics at a minimum:

- The independent contractor's responsibility for certain expenses, such as association fees, renewal fees, supplies, taxes, etc.
- Brokerage compensation splits, schedules, and timing
- The activities that the licensee may or may not perform on behalf of the brokerage

Without a signed independent contractor agreement, a real estate licensee could be considered an employee of the broker, which can increase the broker’s liability for the actions of the licensee while practicing real estate brokerage activities.

Real Success

Of course, when you interview prospective brokers, you need to be very conscientious about reviewing the details of any contract that you sign. Make sure you understand what that broker expects from you, and what you can expect from that broker. Make sure you understand how commission is paid.
Disavowing Responsibility

Most new licensees look for a broker who will show them the ropes, who will be available to answer questions, and who will help them become experienced professionals. This supervisory relationship should continue even after licensees gain experience. The requirement for a broker to supervise his or her licensees and unlicensed employees is imperative as the broker can be held liable for all real estate-related activities. A broker cannot, therefore, disavow responsibility and write a contract with a licensee that in any way diminishes the broker's supervisory obligations.

Insurance

Insurance is a device for spreading the risk of financial loss among a large number of people. By purchasing insurance, a person or company shares risk with a group, reducing the individual potential for disastrous consequences. Insurance can protect both the individual and the business, and both an employing broker and each licensee must give serious consideration to their insurance needs.

General Liability Insurance

In most cases, general liability insurance provides coverage for bodily injury and property damage, paying for legal liability to others resulting from failure to act reasonably (negligence) on the part of the insured or anyone acting on behalf of the insured. Generally speaking, these policies pay the cost of defense in addition to policy limits.

Automobile Insurance

Most states mandate that every driver must carry vehicle liability insurance. Drivers must carry their insurance cards in their vehicle and show it on request by any law enforcement officer. Since real estate licensees often take clients and customers to look at property in their cars, the coverage of a personal automobile policy may not be sufficient to cover this additional risk, and therefore, many licensees get a business automobile policy to reduce the exposure.

Because a business auto policy tends to cost more than a personal auto policy, some licensees may be tempted to keep only a personal auto policy, especially those who rarely, if ever, transport a client or customer in his car. However, many employing brokers will insist upon a business auto policy with a hold harmless clause because of the liability they have for affiliated licensees. While each company's guidelines can vary on this point, employing brokers may choose to require proof of insurance and make it part of their office policy to verify that insurance annually.

Errors and Omissions (E&O) Insurance

Errors and omissions (E&O) insurance is professional liability insurance that protects licensees from mistakes or negligence. A typical policy pays legal fees and judgments resulting from real estate activities. In a constantly changing profession with large and complex transactions, E&O insurance is critical. Some brokerages will carry a policy—issued in the name of the brokerage—that covers all affiliated licensees for an additional fee. Depending on the state, employing brokers may be required to carry E&O insurance, so it's up to every licensee to confirm coverage with the brokerage.
Common claims that are excluded from E&O coverage include:

- Intentional misrepresentation or fraud
- Transactions involving buying or selling one’s own real estate
- Civil rights violations
- Commercial environmental issues

It’s critical for licensees to understand specifically what is and is not covered so that they do not stray outside of the parameters of the policy. There are cases where E&O insurance does not cover a licensee who is working outside of his area of expertise. An example of that is a residential real estate licensee attempting to do a commercial transaction. The commercial transaction goes wrong, and litigation follows, but the act is not covered.

**Professional Organizations**

The main organization real estate licensees join is the National Association of REALTORS® (NAR). To be a full member of NAR, a person must be licensed in a state and must join a local real estate board that is a member of the National Association of REALTORS®. A new licensee doesn’t automatically become a REALTOR®. Only those who join NAR may use the term REALTOR® because it is a registered trademark. Members agree to voluntarily abide by the REALTOR® Code of Ethics and Standards of Practice.

**Benefits of NAR Membership**

Membership in NAR is not mandatory unless your sponsoring broker is also a member. Many licensees choose to join to take advantage of the benefits of membership, including the following:

- Participation in the multiple listing service (MLS)
- The right to use the trademarked term REALTOR®
- A political and legislative voice at all levels of government defending the interests of the real estate industry
- Education and training that allow agents to earn professional designations
- Real estate business publications
- The use of standardized real estate forms

**Multiple Listing Service (MLS)**

A multiple listing service is an arrangement whereby local member brokers agree to share listings and further agree to share commissions on properties sold jointly. The MLS generally consists of online computer services, updated regularly to include new listings.
Professional Designations

The National Association of REALTORS® offers many programs and services to assist members through various societies and institutes to increase their professional knowledge and skills. NAR and its affiliates award professional designations indicating successful completion of required courses of study. This is a partial list of the institutes and societies of NAR:

- **Accredited Buyer Representative** (ABR). The ABR is awarded by the Real Estate Buyer’s Agent Council and designates membership into the largest association of real estate professionals focusing on all aspects of buyer representation.

- **Certified Commercial Investment Member** (CCIM). Someone with a CCIM designation from the Commercial Investment Real Estate Institute is a specialist in commercial real estate brokerage, leasing, valuation, and investment analysis.

- **Certified Property Manager** (CPM). Awarded by the Institute of Real Estate Management to real estate property management specialists, a CPM title indicates that a REALTOR® is capable of managing residential, commercial, and industrial properties.

- **Certified Residential Specialist** (CRS). Requirements for a CRS designation from the REALTORS® National Marketing Institute include at least 25 transactions (or specific volume of sales) over a specific time period, significant experience, and the completion of educational courses.

- **Counselor of Real Estate** (CRE). A CRE designee is an invitation-only member of the American Society of Real Estate Counselors, a group of professionals who provide seasoned, objective advice on real property and land-related matters.

Real Success

As you continue with your real estate education, you will gain knowledge about a wide range of subjects. While you’re obviously not digging into law as deeply as an attorney, or into finance as deeply as a mortgage broker, as a competent real estate professional, you are expected to understand and keep abreast of the following:

- Federal, state, and local laws and court decisions that affect real estate
- Financing options, costs, and underwriting procedures
- Economic trends and market activity
- Environmental issues
- Contracts, negotiating tactics, and customer service
- Settlement costs and procedures
- Construction materials and techniques

If you ignore these subjects, you shortchange your clients and potentially put yourself and your broker at risk for civil litigation.

Influences on the Real Estate Market

As you pursue your real estate career, it’s important to have some understanding of how the real estate market works. The influences on the real estate market can be divided into four broad factors (remember P-E-G-S): Physical, Economic, Governmental, and Social factors.

While homeownership may not necessarily be for everyone, it’s valuable to consider how the factors affecting the real estate industry might also affect someone’s real, or perceived, impressions about buying or selling a home.
Physical Factors

There are many physical attributes of property that affect the real estate market. Perhaps the most important is location. Therefore, the characteristics of the physical location can have a tremendous impact.

For example:

- Does the topography of the land allow for construction?
- Are there sufficient natural resources to support development?
- Is there proximity to ports, railroads, airports, and other transportation?
- What impact does the climate have on the area?

Uniqueness and Scarcity

The uniqueness and scarcity of real estate are important physical characteristics of land. Uniqueness refers to the fact that each parcel of land, each building, and each house are said to be different. This is also called non-homogeneity ("not the same" or heterogeneous). Even if two houses look the same, they are still held to be unique because of their particular locations.

Scarcity refers to the fact that there's a limited supply of real estate. The land that is on this earth is all there is. Since no more land can be created in any given location, this leads buyers to view land as a scarce commodity. When people want to own property in a thriving area, they must compete with others for the limited supply of land. In areas where jobs, schools, transportation, and perhaps family are nearby, the available housing and buildings to address those needs, or the scarcity of them, are what drives the pricing of real estate up or down.

Immobility

Immobility is a physical characteristic of land referring to the fact that land cannot be moved from one place to another. Buyers are also somewhat immobile. In a good market, the immobility of land positively affects its value since additional land cannot be moved to meet demand. In a bad market, the immobility of land negatively affects its value since it cannot be moved to a better location with buyer demand. Demographic patterns show that most people stay within a given region; this immobility of customers means they cannot easily move to other cities to take advantage of real estate.

For Example

A house in Detroit may be exactly what a buyer in Cleveland is looking for, but it is impossible to move that house from Detroit to Cleveland. Similarly, it is very unlikely the buyer in Cleveland will relocate to Detroit since the buyer’s job is most likely immobile.

Economic Factors

Economic factors cover a broad range of influences on the real estate market. Business cycles are general swings in business activity resulting in expanding and contracting activity during different phases of the cycle. These cycles last for varying periods of time depending on different economic factors.
Many of these activities and factors are so interrelated they can pull other businesses up and down with them. It can be difficult to even out these cycles because the challenge of knowing when they start or what's causing them (although the government does try). Most of the time, a cycle must ride itself out—either to where interest rates or other costs become so high that no one can afford to buy things, at which point, prices begin falling, or where interest rates or costs are so low that even people reluctant to spend can't pass up such low rates or prices and so they begin to spend again.

**Real Estate Cycles**

Real estate cycles are general swings in real estate activity resulting in increasing or decreasing activity and property values during different phases of the cycle. Real estate cycles, also called housing cycles, are dependent on business cycles.

**For Example**

When business cycles are on an upswing, people feel secure in their jobs and have money to spend and invest. This results in increased real estate activity just as it results in increased activity in many other markets and industries.

Conversely, when business cycles are in a downswing, people are worried about their future and are less likely to spend money on real estate or other large purchases. Since the two cycles are dependent on each other, real estate cycles trail behind business cycles because they depend on many elements of business cycles (e.g., steady jobs) to be in full swing before real estate cycles respond.

**Supply and Demand**

Real estate cycle swings are generally the result of the real estate market responding to supply and demand, which states that for all products, goods, and services, when supply exceeds demand, prices will fall, and when demand exceeds supply, prices will rise. This broad market factor plays an important role in real estate because of the inherent difficulties in adjusting supply and demand.

In a healthy economy, supply and demand are more or less in balance, but the factors affecting supply and demand are constantly changing, thereby shifting the balance. There are two factors, though, that may separate the housing market from other supply and demand models. One is the lag time needed for the construction industry to respond to perceived changes in supply and demand if the supply of existing houses is not sufficient. Because of this, real estate cycles could take longer to respond to upswings and downswings than other businesses. The other factor is that there's a limit to the supply of land in any given area, as discussed earlier.

The imperfect ability to react to market changes skews the supply and demand model in real estate, making it more susceptible to a temporary shortage or oversupply of houses. This leads to a seller's market or a buyer's market.

**SELLER'S MARKET** A seller's market is a housing market where there are more buyers than sellers. Therefore, the seller is generally able to negotiate a purchase price that is closer to or higher than the listing price or to negotiate more favorable terms.
This situation may result from:

- People moving into a particular area.
- Lack of new construction (perhaps in response to a previous buyer’s market).
- High construction costs for labor or materials.
- Good economic conditions (e.g., new factory/plant opening, increase in local employment, lower interest rates).

**BUYER’S MARKET** A buyer’s market is a housing market where there are more sellers than buyers. Generally, in this situation, the buyer is able to negotiate a lower price or more favorable terms. A buyer’s market can be somewhat neutralized if some of the sellers take their houses off the market. But a glut is a glut, and there usually remains downward pressure on prices. A buyer’s market may be the result of:

- Population or demographic shifts away from an area.
- Overbuilding by the construction industry.
- Bad economic conditions such as a factory closing or layoffs by a local employer.

**Economic Base**

The single most important factor in determining supply in the real estate market is the economic base, which is the main business or industry that a community uses to support and sustain itself. Essentially, it’s the business or industry that’s responsible for bringing money into the area from outside sources. A community could not sustain itself if it only recycled its own money internally. Residents must expand the economy by selling something to the outside world.

While the presence of an economic base is important for all businesses in a region, it’s critical for the real estate market. Since land can’t be moved from one place to another, its value is determined by the economic health of the community that surrounds it. If the economic base is expanding, the real estate supply will also expand. Property owners will be motivated to sell because the increase in demand will drive prices higher. Later, new construction and the anticipation of continued economic expansion will keep prices high.

If the economic base is shrinking, the real estate supply will also shrink. At first, there’s an oversupply as people sell to move to new jobs or areas. The supply will stay low because new construction will cease, and more people will be forced to keep their property rather than sell at lower values due to falling demand.

**Interest Rates**

Although demand is also greatly affected by the economic base of an area, the single most important factor in determining demand in the real estate market is the cost of money, which is the interest rate people or businesses must pay to use another’s money for their own purposes. When borrowing money to buy a house, you must find a bank or lender with an interest rate you are willing to pay. A bank gets the money it lends from its depositors. The bank needs to offer the depositors an attractive interest rate, too, so it will have enough money to lend and still make a profit.

Low interest rates increase demand for property; high interest rates decrease demand. Interest rates outweigh the economic base factor in determining real estate demand because even when an economic base isn’t growing, real estate activity can be spurred by lowering interest rates.
Inflation

**Inflation** is *an increase in the cost of goods or services*. This is also called **cost inflation** because it’s the result of manufacturers and others passing along increases in their costs to the consumer. With real estate, cost inflation mostly affects new home prices as builders pass along their higher costs for labor and materials.

Inflation is also defined as too many people having money to spend but few goods on which to spend it. This is called **demand inflation** since too many people want to buy the same thing. In real estate, demand inflation mostly affects existing home prices when many people want to live in a certain area where the home supply is limited.

Low cost inflation has both good and bad effects on real estate. Low inflation is good since it keeps costs down on newly built homes and keeps interest rates low. Low inflation can hinder real estate because wages that aren’t going up quickly or significantly may stop some people from committing to buy a home, and low inflation can flatten prices for existing homes, making people decide to stay where they are rather than selling. Generally, the benefits of low inflation—low interest rates and economic stability—outweigh the disadvantages.

Lower interest rates that go with low inflation are generally good for real estate. When rates are low, more people can afford mortgage payments and are willing to make a commitment.

**Government Factors**

The role of **government** and its effect on the real estate industry cannot be overlooked:

- At the **local** level, planning and zoning, property taxation, building and health codes, and regulations affecting development play a significant role in the cost and desirability of real estate.

- At the **state** level, developmental agencies overseeing roads, waterways, and other factors that affect overlapping jurisdictions are impacted.

- At the **federal** level, legislation affecting the operation of lending institutions has had an enormous effect on the real estate profession. As a matter of fact, many federal government actions are a deliberate attempt to counteract business cycles.

The government can exert additional influences on real estate markets through its **police powers** to place restrictions on the use of land, as well as its mortgage **loan programs** and its participation in the **secondary mortgage market**. We will look at these factors in detail in later chapters.

**Fiscal Policy**

**Fiscal policy** is the federal government’s plan for spending, taxation, and debt management. The legislative and executive branches of government enact fiscal policy by passing legislation that sets the government’s priorities for how much money will be collected, how it will be collected, and how it will be spent. The ultimate goals are supposed to be economic growth and full employment. Unfortunately, there’s much debate over which policies actually produce those results.
Monetary Policy

Monetary policy is the means through which the federal government can exert control over the supply and cost of money. The Federal Reserve Board (also referred to as the Fed) is responsible for U.S. monetary policy and commercial bank regulation. Among the stated goals of the Fed's policies are higher employment, economic growth, price stability, and interest rate stability.

We’re most concerned with the effects of the Fed’s monetary policy on interest rates. Although the Fed does not set the interest rates that banks charge for mortgages, these long-term rates usually follow the lead established by Fed policy. We will look at the Federal Reserve in more detail in a later chapter.

Taxation Policy

Specific tax policies can encourage or discourage certain behavior or activity. Some tax policies have a direct and deliberate effect on real estate. State and local governments may give tax breaks to businesses as an incentive to bring jobs or real estate development to an area, for example. At the federal level, allowing deductions for home mortgage interest encourages home ownership and stimulates housing activity.

Specific tax policies can also adversely affect real estate. On the local level, high real estate taxes that generate revenue for school districts may mean better schools, but they can also discourage new home construction.

Be aware that although tax laws can influence real estate, never give tax advice to anyone. Tax laws are complicated and change often, so you should encourage people to consult with tax professionals.

Social Factors

Social factors also have an important impact on business cycles and real estate cycles. These factors include changes in demographics as well as in buyer's tastes and other trends. For example, the increase in the number of people in their prime home-buying years can push up housing prices and influence supply. Smaller families, higher divorce rates, and a trend toward later marriages also stimulate demand since there are generally fewer people per household. There are other social factors:

- **Location.** There is also a social element to location. Areas go in and out of favor with the public because of job availability, climate, and other reasons, and this can impact real estate values. It's easy to understand that homes in a growing, popular, and prosperous neighborhood are more highly sought after and valued than those in other neighborhoods.

- **Demographics.** Demographics refers to the makeup of a specific area, including overall population growth and growth rate, population age, and family size. As populations change, so do their housing needs. Growing populations need more housing; however, changes in family size may dictate that new houses should be smaller. An aging population may call for more residences geared to the lifestyle needs of older homebuyers and senior citizens.
• **Migration.** General trends of movement toward, for example, one city over another or one area of town over another impact the real estate market. Migration could be the result of an economic factor (e.g., a factory moving in or out of an area) or a governmental factor (e.g., higher or lower state/local taxes). But these population shifts may be based on an equally powerful social factor, such as an aging population. Migrations affect all business, but migrations have a more significant impact on the real estate market because land cannot be moved or created to fill the demand.

• **Trends and Tastes.** Social trends encompass many aspects of the previous two categories, as well as such things as single-parent households, people buying houses later in life, and the growing number of empty nest households. Each of these trends has the potential to affect the value of certain types of real estate (e.g., large houses may become less desirable as some of these social trends continue).

### Challenge Activity

*Consider whether the situation could best be described as a Physical, Economic, Government, or Social factor by placing a checkmark in the appropriate box(es).*

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<td>2. The property's exact position in a neighborhood, city, and region.</td>
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<td>7. The relative supply of available houses.</td>
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<td>8. Tax breaks and other tax policies.</td>
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<td>9. Trends such as single-parent households or empty nest households.</td>
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<td>10. The topography of the area.</td>
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<td>11. The presence of or lack of water.</td>
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<td>12. The current interest rate.</td>
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<td>13. The availability of schools in the area.</td>
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<td>15. Empty nesters looking to downsize.</td>
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Summary

1. Licensed real estate sales professionals obtain listing contracts from sellers, then search for ready, willing, and able buyers for their listed properties. Salespersons can also choose to work with buyers and show them properties listed by other brokers. **Advantages** to real estate sales include **unlimited compensation potential** from commissions, **controlling one’s own time**, minimum office time, and **potential to own their own brokerage** with additional training, education, and experience. **Disadvantages** include possible fluctuating income, seasonal/cyclical real estate swings, and the need to work evenings and weekends.

2. Four main areas to consider when choosing a broker are **level of training**, **broker services**, **compensation structure**, and the **broker-salesperson relationship**. Training can include assistance with filling in contracts and forms; phone time; and advice on how to close a sale. Services may include administrative support, advertising, and communications tools. Commission splits vary but can increase if the licensee pays for his own supplies, services, monthly office fee, etc.

3. Most brokers have salespeople who are **independent contractors** and pay them based on jobs completed rather than hours worked. Independent contractors are responsible for setting their own hours and paying their own taxes. Both parties must sign an **independent contractor agreement** detailing this arrangement.

4. Areas of specialization within real estate sales include **residential properties** (single-family residences, multi-family residences, condominiums, cooperatives), **commercial properties** (including property management), **industrial properties**, **farm properties**, and **vacant land**.

5. Real estate licensees must join the **National Association of REALTORS® (NAR)** and affiliated state and local boards if their broker is a member. Benefits to joining include access to **Multiple Listing Service (MLS)** and use of the term REALTOR®. Only members may use the term REALTOR® because it is a registered trademark of NAR.

6. **Physical factors** that influence real estate markets include location, **immobility** (land cannot be moved), **uniqueness** (land cannot be duplicated), and **scarcity** (land cannot be created).

7. **Economic factors** that influence real estate markets include **business cycles**, **housing cycles**, **supply and demand**, **inflation**, **cost of money** (interest rates), and the **economic base** of an area. **Housing cycles** are general swings of increasing or decreasing activity and property values; they depend on business cycles.

8. The law of **supply and demand** says that for all products, goods, and services, when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise. There is an inherent difficulty in adjusting supply and demand in the real estate market because an immobile, unique, and scarce product is being sold instead of a commodity and there is a lag time before builders can respond to a shortage or oversupply of houses in an area. This creates **buyer’s markets** and **seller’s markets**.
9. **Inflation** is an increase in the cost of goods or services. When manufacturers pass their increased costs to their customers, it is called **cost inflation**. Inflation caused by too much money chasing too few goods is called **demand inflation**. **Cost of money** is the interest rate people or businesses must pay to use another’s money for their own purposes. Inflation can push interest rates higher or lower, which are a primary factor in determining the demand for real estate.

10. The **economic base** of an area is the main business or industry a community uses to support itself. A healthy economic base is critical to maintaining home values primarily due to the immobility of real estate (and customers). The economic base of an area is a primary factor in determining the supply of real estate.

11. **Governmental factors** that influence real estate markets on state and local levels include **revenue generating laws** (taxation and specific tax policies). The Federal Reserve also uses various tools to influence interest rates.

12. **Social factors** that influence real estate include **demographics, population growth, population age, family size, and population migration**. Land values can benefit from an influx of people (for jobs or other reasons) or be devastated by a mass departure of people.
Chapter Quiz

1. In general, a real estate licensee may NOT accept compensation for selling ____________ on behalf of a client.
   A. commercial property
   B. securities
   C. timeshares
   D. vacant land

2. The majority of new licensees begin their work in what market?
   A. commercial properties
   B. multi-family residential
   C. property management
   D. single-family residential

3. An independent contractor licensee
   A. cannot be charged for office space or supplies provided by the broker.
   B. earns commission based on the results of his or her work efforts.
   C. is subject to strict direction or control by the broker.
   D. is paid for the number of hours worked.

4. Which is NOT one of the factors used by the IRS to determine whether a real estate agent qualifies as a statutory non-employee?
   A. has a fiduciary relationship with clients
   B. paid for output, not hours worked
   C. properly licensed
   D. written and signed contract with broker

5. At the end of the year, what form will an independent contractor receive that details his or her compensation for the year?
   A. 1040 ICA
   B. 1099-MISC
   C. W-2
   D. W-4

6. An employer is responsible for withholding each of these from an employee’s paycheck EXCEPT
   A. income tax.
   B. Medicare tax.
   C. property tax.
   D. Social Security tax.

7. Salesperson L uses the multiple listing service to find the perfect house for buyer B. When B buys the house, who will give L a check for the commission he earned?
   A. B, his buyer client
   B. L’s broker
   C. the manager of the multiple listing service
   D. the seller

8. Which is NOT an advantage of a career in real estate sales?
   A. possibility of owning your own brokerage with additional training, education, and experience
   B. potential for unlimited earnings
   C. setting your own hours
   D. predictable income

9. When may a person use the term REALTOR®?
   A. after closing the first successful transaction
   B. as soon as the person passes the real estate license examination
   C. only after becoming a member of the National Association of REALTORS®
   D. upon the sponsorship of his or her broker

10. The multiple listing service (MLS) was created so that
    A. agency agreements and disclosures would not be necessary.
    B. brokers could have a secure place to record a client’s confidential information.
    C. member brokers could share listings with a blanket offer of cooperation and compensation.
    D. sellers and buyers could find each other.
11. ABC Cable Inc. is getting ready to build a new call center in Smithton that should attract hundreds of new workers to the small town. What would you expect the immediate effect on home prices in the area to be?
   A. Home prices should fall initially.
   B. Home prices should rise initially.
   C. Home prices should not be affected.
   D. It's not possible to predict.

12. A large influx of people into a community is likely to result in which type of real estate market?
   A. buyer’s market
   B. seller’s market
   C. should not affect the market
   D. impossible to predict

13. What is the most important factor in determining supply in the real estate market?
   A. economic base of an area
   B. government programs
   C. interest rates
   D. population growth

14. What is the impact of low inflation on the real estate market?
   A. It generally raises interest rates.
   B. It decreases the cost of a newly built home.
   C. It increases the price of existing homes.
   D. The market would not be affected.

15. What factor is NOT LIKELY to contribute to a buyer’s market?
   A. increased layoffs at a local factory
   B. limited new construction
   C. low construction costs for labor and materials
   D. migration away from the area

16. Which situation would NOT LIKELY result in a seller’s market?
   A. high construction costs
   B. low interest rates
   C. migration out of an area
   D. minimal new construction

17. What is the acronym you can use to remember the broad factors that impact the real estate market?
   A. P-A-T-S
   B. P-E-G-S
   C. P-E-T-E
   D. P-I-T-I

18. What is another word that refers to the non-homogeneity of real property?
   A. immobility
   B. scarcity
   C. uniformity
   D. uniqueness

19. An increase in the cost of goods or services is known as
   A. the cost of money.
   B. economic base.
   C. inflation.
   D. lag time.

20. Which is NOT a physical characteristic of land?
   A. balance
   B. immobility
   C. scarcity
   D. uniqueness
Real Property Fundamentals

The law classifies all property as either real property, which is land and everything attached to it, or personal property, which is any property that is moveable and not attached to the land.

The distinction between the two becomes important whenever the ownership or possession of land is transferred. In this chapter, we’ll clarify the difference between real and personal property and discuss strategies to minimize disagreements about what is real and what is personal.

After reading this chapter, you will be able to:

· Distinguish between real property and personal property.
· Recall various rights inherent in real property ownership.
· Discuss strategies for resolving property disputes.

Key Terms

Accession  Chattel  Littoral Rights
Accretion  Emblement  Personal Property
Alluvion  Encroachment  Real Estate
Annexation  Erosion  Real Property
Appropriative Rights  Fixture  Reliction
Appurtenance  Fructus Naturales  Riparian Rights
Avulsion  Leasehold Improvement  Severance
Bill of Sale  Improvements  Trade Fixtures
Bundle of Rights  Land

Accession  Accretion  Alluvion  Annexation  Appropriative Rights  Appurtenance  Avulsion  Bill of Sale  Bundle of Rights  Chattel  Emblement  Encroachment  Erosion  Fixture  Fructus Naturales  Leasehold Improvement  Improvements  Land  Littoral Rights  Personal Property  Real Estate  Real Property  Reliction  Riparian Rights  Severance  Trade Fixtures
The Nature of Real Property

Many people who are looking at buying “real estate” say that they are looking for a house. After purchasing real estate, they say that they have just bought a house. Although these statements are correct, the house is only one element that they now own. Other elements include the land, air rights, and objects attached to the land. Interestingly, some of the things that a new owner might think should be sold with the property might not actually be considered part of the property. For example, disputes can occur between a buyer and seller where one or the other thought that an appliance was or was not included in a sale. How do you keep these disputes from happening so that a sale goes smoothly? It is first by understanding the nature of real estate, real property, and personal property.

Land

Land is legally considered to include the surface of the earth, the subsurface to the center of the earth, and the air above the land. One way to understand the rights that accompany land ownership is to imagine the property as an inverted pyramid, with its tip at the center of the earth and its base extending out into the sky. An owner has rights to the surface of the land within the property’s boundaries, plus everything directly over the surface and everything under the land within the pyramid.

Legal descriptions define a parcel of land by detailing only the surface. The law states subsurface and air rights are included as part of the land even though they are usually not documented.

Real Estate

Real estate is defined as the actual physical land (also known as unimproved land or raw land) and its permanent attachments, both natural and man-made.
Man-Made Attachments

Man-made attachments are called fixtures. A fixture is an item of personal property that may or may not be attached to real property but is closely associated with real property in such a way that it has, and is intended to, become part of the real property. A major fixture that significantly increases the value of the property (e.g., a building) is commonly called an improvement.

Fixtures become real property through one of several methods:

- Becoming physically attached to real property
- Becoming attached conceptually because of a close association with real property (such as the keys to a house)
- Becoming attached through the process of adoption; for example, curtains that were custom-made for an unusual window size or shape or even wall-to-wall carpeting
- Becoming part of the real property through an agreement between the parties involved (such as a landlord and a tenant)
- Becoming part of the property because its removal would damage the property
- Become part of the property because of the intention of the person affixing the personalty to the real estate

Fixtures can be detached from the land and so revert back to personal property through the process of severance, for example, when a chandelier is removed from the ceiling.

Natural Attachments

The definition of real estate also encompasses natural attachments, in other words, the plants growing on the land. Trees, natural vegetation, and perennial plants are called fructus naturales, or fruits of nature. They can either be naturally occurring or planted.

Emblements The proper term for flowers, crops, and other vegetation that are planted or cultivated annually or seasonally is fructus industrials, meaning fruits of industry. Another word for fructus industriales is emblements. Emblements are considered personal property.

For example, a rose bush growing on the land is part of the real property. Once the flowers are picked, however, they become personal property. The same rule applies to crops. Until they have been harvested, the crops are part of the real property. Thus, unharvested crops are treated as part of the real property in a sale of land. The buyer takes title to the grains, fruits, or vegetables unless it is specifically agreed that the crops are to be excluded from the sale.

Many states recognize the doctrine of emblements, which allows a tenant farmer to re-enter the land to harvest crops that were planted by the tenant farmer even after the land has been sold to a new owner.

Real Property and the Bundle of Rights

When someone buys real property, they get the land, the attachments, plus a bundle of rights (also called the bundled of sticks) that are granted when they take ownership of the property:

Possession The right of possession gives the owner the right to physically occupy the land and to use the land and make it productive. Owners can use the land in any way they want, as long as it is legal and does not interfere with other people’s rights.
DISPOSITION  The right of disposition allows the owner to transfer all or some of the rights to other people. For example, landowners normally have the right to sell, lease, give away, divide, and retain part of the land or to dispose of it completely. An example of partial disposition would be someone who sells 10 acres of his 100-acre farm. Another example of partial disposition would be a landlord who rents an apartment, allowing someone else to possess part of the property, even if temporarily.

QUIET ENJOYMENT  The right of quiet enjoyment gives the owner the freedom to possess and use the land without interference from other people or society. However, this also includes a responsibility to make sure that their neighbors’ enjoyment is not hindered or adversely affected.

EXCLUSION  The right of exclusion allows the owner to stop others from using the property or even from entering the property.

CONTROL  The right of control allows the owner to physically alter or change the property. For example, a property owner can build a garage, tear down a fence, put in a swimming pool, etc. Of course, there could be zoning issues related to this, which are covered in detail in a separate lesson.

Appurtenances

Appurtenances are rights that transfer with real property, or “run with the land.” Licensees need to know what items are considered part of the real property and understand what rights are transferred along with it. An owner has rights to the surface of the land within the property’s boundaries, plus everything under or above the surface. This includes rights to oil and minerals beneath the surface and certain air and water rights.

When an owner sells real property, she usually transfers appurtenant rights along with it. The seller can, however, sell appurtenances separately if she hasn’t already sold them in a previous transaction.

For Example

J inherits 75 acres of land and decides to build a house. A previous owner found natural gas on the land and had sold the natural gas rights to the gas company, so J doesn’t inherit those rights. While the builders are clearing an area for the house, they find coal. J moves the location of his home in order to contract with a company to extract the coal. Later, J dies and his son, P, inherits the property. P doesn’t want the property or the house, so he sells the property but keeps the coal rights.

Air Rights

Air rights for a property owner mean the right to the air space above the property to the upper limits of the sky. Historically, that meant to the outer reaches of the air space. Cases have limited the air space to that which can reasonably be used. And, because of air travel, Congress has modified air rights by giving the federal government control over U.S. air space. Now, property owners still have the right to use the lower
reaches over their land, but they may not interfere with air traffic. Giving the federal government control of the air above property does not mean that owners give up basic rights. Owners still have the right not to be harmed by the use of the air space above their property.

A property owner may also sell rights to the airspace over a property separately from the land.

**For Example**

In cities where downtown land is at a premium, shopping centers or offices may be built above roadways and railways. In these instances, the company or individual who owns that land may have to provide an easement to allow for the construction and support of the buildings. Also, someone who buys a unit in a high-rise building purchases not just the physical condominium, but also the airspace in which the unit is situated.

**Mineral Rights**

A landowner owns all the solid minerals in or under the land. Minerals are considered real property until they are extracted from the earth. A landowner may sell or lease mineral rights separately from the surface land, and many do, especially if they do not have the necessary skill or equipment to mine or drill.

Oil and gas are governed by the rule of capture, which says *whoever drills a well on their land owns all the oil or gas the well produces even though it may have migrated from under a neighbor’s land*. A landowner can drain oil or gas from beneath owned land and from neighboring land because oil and gas flow toward the point of lowest pressure, which is typically where the reservoir was pierced by the well. The rule of capture is designed to stimulate oil and gas production since the only way to stop oil or gas from going to a neighbor’s well is by drilling your own.

**Supporting Rights**

A landowner also has supporting rights. A piece of land is supported by the land that surrounds it. A landowner has a right to the natural support provided by land beside and beneath it.

- **Lateral support** is support from adjacent land. A neighbor’s excavations may make your land shift and settle. In some cases, the neighbor can be held liable for resulting damage if there was negligence.
- **Subjacent support** is support from the underlying earth. Generally, the mining party is liable for surface damage caused by underground mining even if excavations were performed carefully.

**Water Rights**

There are two main ways that water rights can be acquired:

- Ownership of land (riparian rights)
- Granted through government permits (appropriative rights)
Many states east of the Mississippi River or states that have an abundance of water tend to have statutes that grant riparian and littoral rights. States west of the Mississippi, especially where water can be scarcer, tend to have statutes that grant appropriative rights. This doesn’t mean that all of the different rights aren’t found in different states. It just means that there might be more of an emphasis on one set of rights.

**RIPARIAN RIGHTS** Riparian rights are the water rights of a landowner whose property adjoins a river, lake, or other body of water. Any land adjacent to water or crossed by water is riparian land. The terms “riparian rights” and “riparian land” also encompass the terms “littoral rights” and “littoral land.” Littoral rights are the water rights of landowners whose land touches a commercial lake, sea, or ocean. Technically, riparian rights are associated with rivers, and littoral rights are associated with lakes, but the term “riparian” is more commonly used and usually refers to both types of water rights.

**Percolating rights** involve the use of underground water. For example, landowners have the right to install wells to access water for their own use.

The owner of riparian land has the right to make reasonable use of the water. Keep in mind that having the right to use the water is not the same thing as owning the water. All the riparian landowners on a river or lake share the right to use the water for recreational purposes. They also share the right to take water for domestic purposes (e.g., drinking, washing, watering a garden).

Riparian owners can also take water for other purposes (e.g., irrigation, power). These uses, however, must not be wasteful or interfere with other riparian owners’ use of the water. An upstream owner also may not unreasonably diminish the flow or the quality of the water, which would prevent downstream owners from using it to their full and rightful advantage.

**APPROPRIATIVE RIGHTS** Appropriative rights are water rights granted by government permit independent of land ownership. This may be referred to as the doctrine of prior appropriation. Government permits allow the holder to take water from a particular body of water for a specified use, such as crop irrigation. Usually, the water usage needs to be for a beneficial project. The issuing of permits controls the use of water in areas where water can be scarce and protects the water resources in a state. Appropriated water does not have to be used on riparian or littoral land, but riparian and littoral landowner rights are considered when issuing appropriation permits. Still, appropriative rights usually cannot interfere with riparian or littoral rights.

**Accession**

When an item or land become part of a parcel of real property, the owner acquires title through accession, which is the acquisition of title to land by its addition to real estate already owned, through annexation or natural forces.

**Annexation**

As a general rule, annexation transforms personal property into a fixture that becomes part of the real property; the owner of the real property also becomes the owner of the annexed property. For example, when someone builds a house, installs a swimming pool, or plants a tree, personal property is annexed to real property.
Natural Forces

While land is considered to be indestructible, there are forces of nature that can cause the land to move or change shape. Through such forces, the value of property—and even title to the property—can be affected.

- **Erosion.** A *gradual loss* of soil due to the action of wind, water, or other forces. Water can include rain or flowing water. If the eroded soil moves over property lines, property owner X loses title to the soil, and property owner Y acquires it.

- **Accretion.** A *gradual addition* to dry land by the forces of nature, such as when the tide deposits waterborne sediment on shoreline property. These deposits are called *alluvion* or *alluvium*. Riparian or littoral property is often increased this way, and the landowner gains the title to the silt.

- **Avulsion.** A *sudden* process where land is violently torn away by some natural force such as flowing water, mudslide, or earthquake; for example, a river suddenly changes its channel due to a flash flood. Avulsion doesn't transfer title if the original owner identifies and reclaims the severed land.

- **Reliction.** The *gradual receding* of water from a shoreline, exposing more of the waterbed. This exposed land mass becomes part of the owner's property. One cause for reliction is the gradual evaporation of the water. If the property owner already owned the land under the water, reliction does not increase the amount of property owned.

Interfering with Real Property Rights

There are certain activities that can interfere with a property owner's bundle of rights:

- **Trespass** is a physical invasion of land by another person who has no lawful right to enter it. Trespassing interferes with the owner's bundle of rights, diminishing the owner's right of use and right of quiet enjoyment since, during the trespass, the owner of the land has less than full possession of it.

- **Encroachment** occurs when a physical object intrudes onto neighboring property, often due to a mistake with the boundary. It is similar to trespass but involves objects instead of people. Thus, a neighbor's driveway built over your property line encroaches on adjacent land. A tree growing over a property line is another example of an encroachment. A landowner can take legal steps to force a neighbor to remove the encroachment by tearing it down, trimming the tree, or buying the land on which it sits.

- **A nuisance** is anything that interferes with the quiet enjoyment of land from another person's property such as loud noises, unsightliness, and obnoxious odors. A nuisance does not involve possession of the property. To be actionable in court, a nuisance must be a continuing unreasonable use of land by the offending landowner, but a court usually will not support an action if a landowner bought the property with knowledge of the nuisance.
Accounting for Personal Property

Personal property is most easily defined as any property that is not real property. It is typically considered to be temporary and moveable, thus not fixed to the land. Personal property is also called chattel or personalty. Examples of personal property are detached household furniture, appliances, clothing, automobiles, jewelry, etc.

Personal property can be further classified as either tangible or intangible:

- **Tangible** property is something that can be touched or held. When you think of personal possessions, such as a car or book, you are thinking about personal property. Also, tangible property can be things that you might not consider personal property, such as a cat or harvested crops. All of these things can be moved.
- **Intangible** property is something that cannot be held or touched, for example, accounts receivable, stock rights, a lease, or intellectual property.

While a deed usually serves to transfer real property and its attachments, a separate bill of sale generally transfers ownership of personal property.

Fixture or Personal Property?

Unless otherwise established, all real property is included in the transfer. Although fixtures and improvements are attached to the land, they should still be specified in purchase agreements to eliminate any potential differences of opinion. Personal property that happens to be on the premise is not included. Thus, when there is a disagreement between a seller and a buyer about property, it can often be traced back to how the property is classified. This can be a result of determining if the property is attached or not, or even what exactly is intended to be transferred with the actual land.

Resolving Disputes: Key Questions

In some cases, these types of disputes end up in court. These are the legal questions necessary to determine if an object is a fixture, in other words, not personal property:

- What was the intent of the person installing the item?
- How was it attached, and can it be removed without damaging the property?
- Was the item custom-made or designed specifically to fit or be used in the property?
- What is the relationship between the parties?

**Intention**

To determine whether an item is a fixture, it's necessary to consider the intention of the person who added it (the annexer), and the purpose for the addition. Did the property owner intend for the fixture to become part of the real property or to remain as personal property? Was it made specifically for the property? Did the property owner buy the item to improve the real property or simply purchase it with the intention of taking it once the property is sold?

To answer these questions, the court will look for objective evidence of the annexer's intent. It's not enough to claim that the item was custom-made for the property or that the property owner had always intended to remove the item.
Manner of Attachment

Although a court may consider the manner of attachment—or how it is attached—that is just one factor and doesn’t carry more weight than other factors. There are two classifications for the annexation:

- **Actual Annexation.** A fixture is physically attached to real property, for example, a two-car garage.

- **Constructive Annexation.** Personal property is associated with real property in such a way that the law treats it as a fixture because it is important to the use of the real property, even though it’s not attached to the real property, for example, the key to a house.

Some factors that a court might use to determine the manner of annexation are the permanence of attachment and the difficulty of removal and any potential damage that might result.

Relationship of the Parties

Another factor that a court may consider in fixture disputes is the relationship of the parties. Between a seller and a buyer of real property, the rules for determining whether an item is a fixture are usually interpreted in favor of the buyer. Between a landlord and a tenant, the rules tend to be interpreted in favor of the tenant. A tenant who installs a chandelier, for example, usually has the right to remove it at the end of the lease. These rules are tied to the annexer’s intentions—the law generally presumes a homeowner intends to improve real property, but a tenant installs things only for personal use.

Individual state laws vary on fixtures, however, so it’s important to understand the statutes in the jurisdictions in which you practice and don’t make any inferences about who would win a dispute.

That doesn’t mean a tenant is invariably allowed to remove everything she installed, especially if she installed items without written permission. If a tenant built a deck onto the back of a rented house, for example, it would almost certainly be considered a fixture and part of the landlord’s real property. As usual, the court would look at the nature of the item, the manner of annexation, and how difficult it would be to remove. Remember: Once a dispute gets to a court, anything can happen!

Written Agreements

Generally speaking, the written word overrides any verbal agreement in a dispute. Sometimes, when buyers and sellers chat privately, a promise to take or leave something can be overlooked in the contract and become a legal dispute by the time of closing. Regardless of the nature of the item in question, write it into the contract so that there is no misunderstanding later.

If there’s a written agreement between the parties stating how an item is to be treated, a court will most likely enforce the agreement according to the court’s interpretation. Care should be taken with the language in the agreement to ensure the court understands the intentions of the parties to the agreement.
Real Success

Is a built-in dishwasher a fixture? Is a shed an improvement? Is a chandelier personal property? Since disputes can still arise between a seller and a buyer, real estate licensees should be prepared to discuss the options. In some cases, a seller won’t want to sell a fixture with a property. In other cases, a buyer might want to purchase personal property that would not normally sell with the real property. Here are two situations and suggested solutions:

The buyer wishes to purchase the seller’s personal property in the sale.

In this situation, buyers might want to include items that normally would not be included in the sale of the property. For example, a buyer really likes the curtains in the living room and would like them to be sold with the house. She should include a list of all personal property items she wants in the purchase offer. The seller can either counteroffer or agree to sell the personal property with the property.

The buyer’s agent should ensure that the agreement of sale accurately reflects this. By having it in writing, there are no assumptions regarding whether something will or will not be included in the sale.

The seller does not want to sell specific fixtures.

Some licensees use what is called a “red tag” method, where the homeowner places a tag on items that are not included in the sale. This might not be the best solution since someone can accidentally remove the tag or buyers may misunderstand the meaning of the tag and think it means that the item is part of the transaction. The safest option is to ensure that the listing agreement clearly indicates any items that might be questionable as either staying or going, so there’s no confusion. Then, of course, confirm the accuracy in any agreement of sale.

One of the best suggestions that a listing agent can make to sellers, however, is to simply remove or replace items they plan to take with them before showing the property. This makes it impossible for a buyer to expect a particular item to be included in the sale and resolves all issues regarding whether the buyer saw the item and assumed it would transfer.

Trade Fixtures and Leasehold Improvements

Trade fixtures are any equipment or personal property a commercial tenant installs for business purposes. While these items may be attached to real property, they remain the personal property of the tenant. Unless otherwise indicated in the lease, the tenant should remove any trade fixtures before the lease ends. For example, a tenant who opens a pizza shop can remove the oven he installed, even though it is attached to the floor. However, the tenant must repair any damage caused by the removal. If a tenant chooses not to remove the fixture, he forfeits it to the property owner.

On the other hand, a landlord can install a leasehold improvement for tenant use. For example, a landlord installs a wood-burning stove in the living room of a single-family home, which attaches it to the house. Courts consider the stove to be the real property of the landlord.
Challenge Activity

Determine whether the items below would best be classified as real (R) or personal (P) property.

<table>
<thead>
<tr>
<th>R</th>
<th>P</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Custom curtains or drapes</td>
</tr>
<tr>
<td>2.</td>
<td>A chandelier the homeowner bought and attached to the dining room ceiling</td>
</tr>
<tr>
<td>3.</td>
<td>Bookshelves that are attached to a wall</td>
</tr>
<tr>
<td>4.</td>
<td>An individual avocado taken from a tree in the front yard</td>
</tr>
<tr>
<td>5.</td>
<td>A built-in dishwasher</td>
</tr>
<tr>
<td>6.</td>
<td>A commercial oven in a restaurant</td>
</tr>
<tr>
<td>7.</td>
<td>A leased water heater tank</td>
</tr>
<tr>
<td>8.</td>
<td>Built-in closet organizers</td>
</tr>
<tr>
<td>9.</td>
<td>A fence that encloses the yard</td>
</tr>
<tr>
<td>10.</td>
<td>Venetian blinds on the windows</td>
</tr>
<tr>
<td>11.</td>
<td>A TV attached to a bracket on the living room wall</td>
</tr>
<tr>
<td>12.</td>
<td>The bracket for the TV mounted on the living room wall</td>
</tr>
<tr>
<td>13.</td>
<td>A washer and dryer hooked up by a tenant for his use</td>
</tr>
<tr>
<td>14.</td>
<td>An unattached kitchen island</td>
</tr>
<tr>
<td>15.</td>
<td>A window air conditioning unit</td>
</tr>
</tbody>
</table>
Uniform Commercial Code

The Uniform Commercial Code (UCC) is a body of statutory law that governs transactions involving personal property. As previously explained, personal property becomes realty when it meets any of the tests for fixtures. The UCC and its procedures protect the vendor of the personal property, the new owner of the real estate, and the seller by fixing the rights of each at the time of the sale of the item to be affixed.

For Example

A furnace crated in a box or on a showroom floor is considered personal property; a furnace installed in a home is considered real property. Homeowner A purchases a furnace by entering into an installment contract with monthly payments. Before paying off the furnace, A sells his home to M. A assumes that M has to pay off the furnace since she bought it as part of the real estate.

However, the installment contract is with A, not M. If the furnace vendor cannot locate A once he moves out of the area, the vendor may try to seek payment from M. However, M can successfully defend herself because she was not a party to the vendor’s contract. M can keep the furnace, and the vendor loses the money from the outstanding payments.

The UCC solves such problems by requiring the vendor to file a financing statement with the county recorder office in the county in which the property is located. This fixture filing includes a legal description of the land as well as the name and address of the landowner. In this way, all parties are protected. Since the home buyer would know about the debt, the seller might not be able to convey marketable title without paying off the furnace. The vendor would likely receive proper payment and not need to seek satisfaction through litigation. Vendors must file financing statements in a timely manner, or lose their rights against the owner.
Summary

1. **Real property** is defined as land and everything attached or appurtenant to it. Real property rights are defined in terms of a **bundle of rights** that are conferred by ownership. These rights are the *right of possession*, the *right of disposition*, the *right of quiet enjoyment*, the *right of exclusion*, and the *right of control*. If one secures the entire bundle of rights from another, that person is said to be the owner. *Trespass*, *encroachment*, and *nuisance* are three kinds of interference with these rights.

2. **Attachments** to real property are part of the real property. The two types of attachments are **natural attachments** (e.g., plants, trees) and **man-made attachments** (e.g., fences, buildings). Man-made attachments are called **fixtures**. A major fixture (e.g., a building) is called an **improvement**. Unless otherwise agreed, attachments transfer with the land; personal property does not. Difficulties can arise over what is considered real property versus personal property.

3. An **appurtenance** is a right that goes with or relates to real property, including *air*, *water*, *mineral*, and *support rights*. These rights are ordinarily transferred with the land, but may be severed from it and sold separately. This is often the case with mineral rights where the owner does not have the skill or equipment necessary to tap these mineral resources. **Mineral rights** are straightforward in that the landowner owns all solid minerals beneath his land. Oil and gas, however, are governed by the **rule of capture**, which states whoever drills a well owns all the oil and gas it produces.

4. The right to use water is either a **riparian right** or an **appropriative right**. All landowners whose property adjoins a body of water have riparian rights to use the water for recreation or personal use on their own land. To acquire an appropriative right, one must obtain a permit from the government, which then allows the permit holder to use water for irrigation or other special uses.

5. A real property owner acquires title by **accession** when something is added to the property, either by **annexation** or by **forces of nature**. Annexation transforms personal property into a fixture, which becomes part of the real property. The forces of nature can *add* to an owner’s land through **accretion**, or *subtract* land from an owner’s holding through **erosion** or **avulsion**.

6. A **fixture** is an item of personal property that may or may not be attached to real property; it is either intended to remain with—or is so closely associated with—real property in such a way that it has legally become part of the real property. In deciding whether an item is a fixture, a court tries to determine the intention of the **annexer**, the manner of annexation, the purpose for which it was annexed, potential damage from removal, and the relationship of the parties. **Written agreements** always take precedence. **Trade fixtures** are an exception to the general fixture rules. Since they are installed by a tenant for use in the business, a trade tenant can remove trade fixtures before the lease period ends.
Chapter Quiz

1. Which is NOT an example of an attachment?
   A. a basketball hoop that is moved into the garage in the winter
   B. a greenhouse that is built off the garage
   C. the lily pond in the backyard Japanese garden
   D. uncut roses on a rose bush planted by the back door

2. What term describes a right that transfers with ownership of real property?
   A. appurtenance
   B. encroachment
   C. emblement
   D. fixture

3. Physical land and all improvements that are permanently attached to it is known as
   A. land.
   B. real estate.
   C. real property.
   D. real and personal property.

4. A landowner needs water. His land contains no available water source. However, the landowner is given the right to cross over his next-door neighbor's property to run a pipeline from a river to his land. Which right grants this permission?
   A. appropriative
   B. littoral
   C. reliction
   D. riparian

5. Over the last several years, the tide has been depositing silt onto the property along a coastal inlet, increasing the size of the property. This is an example of
   A. accretion.
   B. avulsion.
   C. erosion.
   D. reliction.

6. J buys a house from K. J assumed that the curtains would be included in the price, even though the agreement of sale did not list them. What is the best argument J could make to persuade a judge if this goes to court?
   A. “K mentioned that they went with the house.”
   B. “My agent assured me they were included.”
   C. “The curtains were custom-made for the odd-shaped window.”
   D. “The curtains were in the ad that appeared in the paper.”

7. A bench and table are installed as a leasehold improvement in the breakfast nook of a rented single-family home. The bench and table are bolted to the floor and must have been installed by the _______ and would most likely be _______ property.
   A. landlord / personal
   B. landlord / real
   C. tenant / personal
   D. tenant / real

8. B bought a farm, and the sale included two tractors. What is required at the settlement to transfer ownership of those tractors?
   A. bill of sale
   B. deed
   C. purchase agreement
   D. sales contract

9. Which item is LEAST LIKELY to be a fixture?
   A. the built-in washer that’s at the repair shop on the day of closing
   B. the curio cabinet in the living room that matches the room’s decor
   C. the keys to the house
   D. the white picket fence around the house

10. Which of these is NOT considered when determining whether an item is a fixture or personal property?
    A. intention of the annexer
    B. manner of annexation
    C. value of the annexed item
    D. relationship of the parties
11. H owns a small commercial building that he rents to L, who opens a ceramics shop. L installs a kiln. Four years later, H sells the property to A, who wants to start her own pottery business. When L’s lease is up, who owns the kiln?
   A. former tenant L
   B. new tenant A
   C. property owner H
   D. It’s impossible to tell without more information.

12. Which is NOT an example of an improvement?
   A. the barn on the back of the property
   B. the fence running along the edge of the property
   C. the line of pine trees planted along the edge of the property
   D. the sewer line running along the front of the property

13. A homeowner is preparing to build a pool and deck in the backyard. The contractor just delivered a load of lumber and concrete to his house for construction beginning next week. That lumber and concrete would be considered
   A. improvements.
   B. personal property.
   C. real property.
   D. trade fixtures.

14. When J bought D’s house, D turned over the house keys as part of the transaction. The house keys have become real property through the process of
   A. actual annexation.
   B. adoption.
   C. agreement.
   D. constructive annexation.

15. Each of these terms could be used to describe a tractor EXCEPT
   A. appurtenance.
   B. chattel.
   C. personal property.
   D. personality.

16. What is another term for emblements?
   A. fructus industriales
   B. fructus naturales
   C. leasehold improvement
   D. trade fixture

17. Physical land, its attachments, and its bundle of rights is known as
   A. land.
   B. real estate.
   C. real property.
   D. real and personal property.

18. Which is NOT an example of avulsion?
   A. After a storm, part of J’s property collapses in a mudslide.
   B. During a drought, the lake dries up, giving U more land on which to grow a garden.
   C. A flash flood pulls G’s barn and the land on which it sat into the river.
   D. T’s hillside is torn away in an earthquake.

19. G inherits a plot of land from J. A year later, G sells half of the property to K. A year later, K gives her half to A, who sells the mineral rights. This series of events best represents the legal property right of
   A. control.
   B. disposition.
   C. possession.
   D. quiet enjoyment.

20. If a tenancy is terminated before a crop is ready to harvest, a tenant farmer has the right to re-enter the land later to harvest the crop. This rule is known as the doctrine of
   A. appropriation.
   B. appurtenance.
   C. emblements.
   D. fructus industriales.
A person who has a property right or a claim against property is said to have an interest in the property. An interest might allow its holder the right to possess the property either now or in the future, known as a possessory interest. Or, it might grant the right to merely use the property or to place a financial claim against title to the property, as with a lien or easement. These are called non-possessory interests and are discussed in a later chapter. This chapter will focus on possessory interests, which can also be called estates. In addition to being classified according to the time of enjoyment, interests are either freehold estates or leasehold estates.

After reading this chapter, you will be able to:

- Contrast various forms of fee simple estates.
- Describe the difference between conventional life estates and life estates pur autre vie.
- Identify examples of statutory life estates.
- Distinguish from among different types of leasehold estates.

**Key Terms**

- Curtesy
- Defeasible Fee
- Dower
- Estate
- Estate for Years
- Fee Simple Absolute
- Fee Simple Determinable
- Fee Simple Subject to a Condition Subsequent
- Freehold Estate
- Holdover Tenant
- Homestead
- Leasehold Estate
- Lessee
- Lessor
- Life Estate
- Life Estate Pur Autre Vie
- Life Tenant
- Measuring Life
- Periodic Tenancy
- Possessory Interest
- Remainderman
- Reversioner
- Tenancy at Sufferance
- Tenancy at Will
- Tenant
Freehold Estates

A freehold estate is a possessory interest of an indefinite amount of time or without a specific termination date; it may end, but no one knows when that might be. Some events that will end a freehold estate include:

- The transfer of the property to someone else (e.g., the sale of property).
- The death of the owner.
- Foreclosure on the property for non-payment of debt.
- In some states, confiscation of a taxpayer's real property in lieu of unpaid taxes (tax-forfeiture).
- Condemnation by the government under eminent domain.

There are different types of freehold estates: Fee simple estates, defeasible fee estates, and life estates.

Fee Simple Estates

A fee simple estate (also referred to as fee or fee simple absolute) is the fullest freehold estate interest that can exist in real property. When a person is referred to as the “owner” of property, it usually means he holds a fee simple absolute. Since the fee simple estate is absolute, this implies there are no conditions on the property title. It is:

- Inheritable,
- Transferable, and
- Perpetual.

The owner of a fee simple absolute has the right to possess the property for an unlimited period of time, and that right will pass to the owner’s heirs after death. The owner may also choose to sell the property, give it away, or transfer a lesser interest in it.

When a fee simple absolute owner deeds an interest in property to someone else, it is presumed that the entire estate is transferred, unless the deed specifies that it transfers something less. For example, if A owns land in fee simple absolute and deeds it “to B” without any limiting language, B will then own the land in fee simple absolute.

Defeasible Fee Estates

A defeasible fee estate (also called qualified fee or fee simple defeasible) is a type of real property ownership that may be defeated or undone if certain events occur or certain conditions are not met. For example, the grantor (A) could choose to qualify B’s title by including a condition or requirement in the deed language that may transfer property “to B, so long as the house is used as a museum.” If B uses the house for some other purpose, B’s title to the property reverts to A (or if A is no longer alive, to A’s heirs).

A qualified fee estate creates a type of encumbrance on the title because it runs with the land, meaning that the restriction is not against the owner, but is against the property itself. Therefore, the restriction or condition remains with every ownership transfer.

Defeasible fee estates may be classified as determinable or subject to condition subsequent.
DETERMINABLE A **fee simple determinable estate** is a defeasible fee estate that terminates automatically if certain conditions occur. If the conditions occur, the grantor regains the property interest immediately and automatically by filing an **action in forcible entry** through the courts. The law does not give consideration for money paid for the land or any improvements on the land. Until the condition is met, however, the former owner has merely a contingent future interest in the land, which is called a **possibility of reverter**.

This **possibility of reverter** is a reversionary interest, since, if the condition is met, title to the land reverts to the former owner who set the condition.

The legal system today works to avoid the harsh result that completely divests the owner from property in this way is avoided wherever possible. Courts strain to find remedies that will give the new owner an interest that can be protected by law. However, they will use a literal interpretation of the language in a properly prepared deed, especially in the case of property dedicated to a public purpose, such as for a park. In the case of a private sale, rather than a gift, the court will attempt to find the second type of defeasible fee: The **fee simple subject to a condition subsequent**.

SUBJECT TO A CONDITION SUBSEQUENT A fee simple subject to a condition subsequent differs from a fee simple determinable in that there is no automatic reversion of title upon breaking of the condition. The former owner has a **power of termination**, meaning the former owner can take steps to re-enter the land legally and force possession away from the landowner. The former owner must exercise this **right of re-entry** within a reasonable period of time or it disappears. A reasonable period of time differs on a case-to-case basis, but the action the former owner files would be an **action to recover real estate**, rather than forcible entry.

Both of these interests in real property (fee simple determinable with the possibility of reverter and fee simple subject to a condition subsequent with the right of re-entry) are called **future possessory interests** since they do not represent present possessory interests in the property and may, in fact, never ripen into fee simple title.

### Real Success

How do you tell the difference between a fee simple defeasible and a fee simple subject to a condition subsequent? The distinction between them can be very technical and depends on the exact language in the deed.

Something to look for, however, is the phrase "as long as ..." or something similar. When deed language includes that phrase, it is most likely to be a **fee simple determinable** situation. For example, "A grants title to B as long as B does not sell alcohol on the property." If B opens a bar on the property, title automatically reverts to A or A's heirs.

If the deed language indicates "on condition that ...", it more likely to be **fee simple subject to a condition subsequent**. For example, "C grants title to D on condition that the grove of maple trees is not removed." If D cuts down the trees, C or C's heirs can go to court and try to regain title to the property.

Most real estate licensees will not have to worry about the distinction since defeasible fees are rare today. If you encounter one, it's best to refer the client or customer to an attorney who practices real estate law.
Life Estates

Life estates are freehold estates that last only as long as a specified person, called the measuring life, lives. The holder of a life estate is called the life tenant. “Tenant,” in this context, does not refer to a rental or leasing condition, but to the person who has the right to occupy and use the property.

Property owners create life estates for a variety of reasons. For example, an owner grants a life estate to another person to simplify the division of property in a will. Or, an owner may transfer property to someone else and reserve a life estate for himself so the property will not have to be probated after he dies. A conventional life estate may be classified as ordinary or pur autre vie.

ORDINARY LIFE ESTATE With an ordinary life estate, the measuring life and the life tenant are the same person. For example, if A owns property in fee simple, she could deed it “to B for life.” B would have the right to occupy and use the property for the rest of his life. But when B dies, the life estate would terminate.

LIFE ESTATE PUR AUTRE VIE A life estate may also be based on the lifetime of someone other than the life tenant. The grantor could deed the property “to B for the life of C.” B’s life estate would terminate when C dies. This is called a life estate pur autre vie (“for another’s life”). While B has the right to occupy the property and, thus, is called the life tenant, the length of the life estate is measured by C’s life. In this case, C is called the measuring life.

Future Interests

Both types of life estate are a present interest for the life tenant that creates a future interest for the person who will receive and possess the land upon the death of the life tenant or of the person who is the measuring life. This future interest may be reversionary or remainder:

REVERSIONARY With a reversionary life estate, the fee interest in the property reverts to the grantor. If the grantor dies before the life estate ends, the future interest in the estate passes to the grantor’s heirs.

REMAINDER With a remainder life estate, the fee interest in the property reverts to another named person, known as the remainderman. If the remainderman dies before the life estate ends, the future interest in the estate passes to the remainderman’s heirs.

Rights and Duties of a Life Tenant

A life tenant owns an interest in the land that can be sold, mortgaged, or leased. But a person can transfer only the interest that he owns. So, if a life tenant sells the property, the buyers have purchased only a life estate. The buyers’ interest ends when the life tenant dies in an ordinary life estate, or at the death of the measuring life in a life estate pur autre vie. A mortgage signed by a life tenant becomes an invalid lien when the life estate ends. Similarly, a lease signed by a life tenant terminates when the life estate ends, regardless of its terms.

A life tenant may not commit an act of waste to the property, which means using the property in a way that damages it or reduces its market value. Thus, a life tenant has restricted rights of use that are transferred with the life estate. For example, if he cuts timber, he must plant trees. He cannot lease the mineral rights since this would permanently devalue the land. It is the duty of the life tenant to preserve the land for the benefit of the remaindermen or reversionary interest holder.
Furthermore, the life tenant has almost no practical rights of disposal. A life tenant can sell or transfer the life estate to another, but this person would then have the life tenant’s limited right of use. Since a life tenant cannot transfer more rights than those held, a life tenant transfers a life estate in her life, not for the life of the new owner. Thus, a subsequent transfer of a life estate creates a life estate pur autre vie.

**Statutory Life Estates**

Some states have laws creating a **statutory life estate** to protect the interests of a spouse when the other spouse dies or when a spouse attempts to sell or otherwise transfer an interest in real property. Historically, **dower rights** refer to a widowed wife’s interest in a deceased husband’s property, while **curtesy rights** typically refer to a widowed husband’s interest in a deceased wife’s property. However, dower is often used generically for any spouse. States that recognize dower and/or curtesy will legislate how to address property brought into the marriage or property that is acquired during the marriage.

Another type of statutory life estate recognized in some states is called **homestead**. Similar to dower and curtesy, a state’s homestead laws apply to the distribution of the property, affording some protection to a surviving spouse and/or minor children.
Statutory life estates are terminated by divorce and cannot be willed to heirs since they are a life estate interest. Such rights must be released in virtually every real estate transaction involving married sellers. The consequences for the buyer of the land if dower is not released involve, at best, a potential legal battle and could result in a serious compromise of valid title.

Leasehold Estates

A leasehold estate is an interest that gives the holder a temporary but exclusive right to possession of the estate without title. A leasehold estate is more limited than a freehold estate. For that reason, it is sometimes referred to as less than freehold. A leasehold estate is considered personal property.

The holder of a leasehold estate is called the lessee or, more familiarly, the tenant. A tenant has the right to exclusive possession of the property, but only for a limited time. An owner who leases property to a tenant is called the lessor or landlord. Lessors have a leased fee interest in the property. Possession will revert to the landlord when the lease ends.

Estate for Years

Estate for years is any leasehold estate for a fixed time period. In spite of the name, the term does not have to be a period of years. The tenancy may last 10 days, 10 months, or 10 years—any fixed period with a specific beginning and ending date. Estates for years are sometimes called term tenancies.

An estate for years terminates automatically at the end of the specified rental period. Usually, neither the landlord nor the tenant can terminate the lease sooner, unless both parties agree. Ending a lease by mutual consent is called surrender.

Periodic Tenancy

Periodic tenancy is a leasehold estate for a duration of time, not a specific date. It continues from period to period until the landlord or tenant gives the other party notice of termination. The period may be any length of time on which the parties agree. Month-to-month tenancies are the most common. A month-to-month tenancy automatically renews itself at the end of each month, unless one of the parties terminates it. Most states have specific statutes mandating the required timeframe for terminating a periodic tenancy.

Tenancy at Will

Tenancy at will is a leasehold estate with no specified termination date or specified period of time. Either party can end it at any time. The tenancy also has no regular rental period and, in some cases, no rent is paid (e.g., when the tenant is a caretaker), or the rent owed has no reference to periods of time (e.g., “35% of all profits from the tenant’s sales of timber”).

Sometimes, a tenancy at will arises after an estate for years ends. The original lease has expired, but the tenant stays on with the landlord’s permission and without signing a new lease.
If the tenant continues to pay the landlord rent at regular intervals, this can create a **periodic tenancy** instead of a tenancy at will.

Unlike a term tenancy or a periodic tenancy, a tenancy at will *cannot* be assigned to someone else. Also, a tenancy at will automatically ends on the death of either the landlord or tenant, which is not true of the other leasehold estates.

**Tenancy at Sufferance**

**Tenancy at sufferance** is the term used to describe *possession of property by a holdover tenant*. A **holdover tenant** is *someone who came into possession of property under a valid lease, but stays on after the lease expires, without the landlord's permission*. As such, a tenancy at sufferance is not actually a leasehold estate. A tenant at sufferance is not very different from a trespasser, except the tenant at sufferance, unlike a trespasser, originally had a right to be on the property.

A landlord is not required to give a tenant at sufferance notice of termination, but the landlord cannot use force to regain possession of the property. The landlord must use the legal eviction process to remove the tenant. If the landlord accepts rent from the holdover tenant, however, a **periodic tenancy** is created.
Challenge Activity

M owns a duplex on a main road in an urban neighborhood. He lives in half of the dwelling and has various tenants in and out of the other half. M bought the property from P. The deed indicates that M can own the property as long as he does not sell alcohol on the property.

What type of possessory interest does M have in the property? What happens if M opens a bar?

__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________
__________________________________________________________________________

Although the differences between the types of leasehold estates might seem straightforward, they aren’t always. A tenancy for years can turn into a periodic estate, which can turn into something else entirely.

At each step in the following scenario, indicate what type of leasehold estate it describes.

<table>
<thead>
<tr>
<th></th>
<th>Tenancy for Years</th>
<th>Periodic Tenancy</th>
<th>Tenancy at Will</th>
<th>Tenancy at Sufferance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>M’s brother, S, finishes college and has not been able to find the job he wants. M lets him live in the other half of his duplex while he looks for a “real” job. S occasionally gives M some money for bills from his job delivering pizza.</td>
<td></td>
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<tr>
<td>2.</td>
<td>S finally lands a job in another state, so M is now ready to find a tenant for his duplex. After advertising, he finds a nice, quiet computer programmer, L, to rent it. M and L sign a 12-month lease.</td>
<td></td>
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</tr>
<tr>
<td>3.</td>
<td>L is a good tenant, always paying his rent on time. After his lease expires, he stays on without a new lease and continues to pay the same rent every month.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td>A few months pass. L is laid off from his job at the software company; he has no money to pay the rent and no place else to go, so he simply stays put without M’s permission.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td>M has a change of heart and decides that L can stay on for a while, even if he can’t pay rent on any regular basis.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td>L is able to take on some work as a short-term contractor. He now has some income coming in and can pay M $500 per month in rent. Knowing the temporary nature of contracting work, M agrees to let L remain in the duplex month-to-month as long as he pays the rent.</td>
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<td></td>
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</tbody>
</table>
Summary

1. An estate is a possessory interest in real property, entitling the holder to possession now or in the future. There are freehold estates, which have a possessory interest of uncertain duration, and leasehold estates, which give tenants a temporary right to exclusive possession. Freehold estates include fee simple estates, which are inheritable, transferable, and perpetual ownership, and life estates, where ownership lasts as long as a specified person lives.

2. A fee simple absolute is the fullest interest in property. A person referred to as “owner” usually holds a fee simple absolute. The duration of a fee simple defeasible is also unlimited, but a defeasible estate can be defeated or undone if certain conditions are not met, with title reverting back to the grantor (or the grantor’s heirs) either automatically (fee simple determinable with possibility of reverter) or through court action (fee simple on condition subsequent with right of re-entry).

3. A life estate lasts only as long as someone’s lifetime. During a conventional life estate, the grantor holds an estate in reversion, or a remainderman holds an estate in remainder. When the measuring life dies, title to the property passes to the reversionary owner or to the remainderman. Conventional life estates can be ordinary (the measuring life and life tenant are the same person) or pur autre vie (the measuring life is someone other than the life tenant).

4. Dower is an interest held by married persons in each other’s real property that is recognized in some states. A dower creates a statutory life estate for the surviving spouse when the other dies. Spouses should sign a dower release when property is sold. This is generally accomplished when the spouse signs a deed of conveyance. Historically, dower refers to a widow’s interest; curtesy refers to a widower’s interest but dower may be used generically. Similarly, some states offer homestead protection for a surviving spouse and children.

5. The leasehold estates are the estate for years, periodic tenancy, and tenancy at will. A leasehold tenant has a temporary possessory interest but does not hold title. Remember that an estate for years can be any fixed period of time, for example, days, weeks, or months. Tenancy at sufferance describes possession by a holdover tenant.
Chapter Quiz

1. What are the two main types of possessory interest in real property?
   A. easements and freehold estates
   B. freehold estates and leasehold estates
   C. easements and liens
   D. liens and leasehold estates

2. Which statement about a fee simple absolute estate is FALSE?
   A. Fee simple absolute is the highest, freest form of ownership.
   B. A fee simple absolute estate is both transferable and inheritable.
   C. A person can own a fee simple absolute estate indefinitely.
   D. A person transferring a fee simple interest can put no limitations on the new owner.

3. V owns 20 acres of land in the mountains and decides to deed the land to a cousin. V wants to ensure that the pristine beauty of the property is not marred by development and indicates in the deed that at least 10 acres must remain undeveloped. This is an example of
   A. fee simple absolute.
   B. fee simple defeasible.
   C. leasehold.
   D. life pur autre vie.

4. J sold his land to F with the condition that F does not disturb the spring house built in 1750 that's on the back of the property. When F tore the spring house down to install a swimming pool, J exercised his right of re-entry. What type of estate did J grant F, and what does J have to do to get the land back?
   A. determinable fee estate; J gets the property automatically
   B. determinable fee estate; J goes to court
   C. fee simple subject to a condition subsequent; J gets the property automatically
   D. fee simple subject to a condition subsequent; J goes to court

5. B owns property in fee simple. He grants a life estate to Z and a remainder estate to X. The life estate is based on Z's life. Life tenant Z CANNOT
   A. give the life estate away to someone else.
   B. live on the property.
   C. sell the life estate to a stranger.
   D. will the life estate to a family member.

6. G bought a house for K to live in, although G remains the owner. When K dies, G wants to retain possession of the property. Who will own the property when K dies and what is that person called?
   A. The owner of the property will be G, who is the remainderman.
   B. The owner of the property will be G, who is the reversioner.
   C. The owner of the property will be K's heir, who is the new life tenant.
   D. The owner of the property will be K's heir, who is the remainderman.

7. M conveys a life estate to N for as long as P shall live, and then to T. N dies before P dies. Now who has the present interest in the estate?
   A. M, the grantor
   B. N's heirs
   C. P, the measuring life
   D. T, the remainderman

8. H has lived in her home for 30 years with her sister A. H's son E will inherit H's estate, but she wants to ensure A is still allowed to live in the home if she dies before A. H grants A a life estate. When H dies, which statement is TRUE?
   A. A has a life estate where she is the life tenant and H is the measuring life. E is the remainderman.
   B. A is both the life tenant and the measuring life for the estate; E has a reversionary interest.
   C. A is the measuring life of this life estate and E is the life tenant with a reversionary interest.
   D. A's life estate ends when H dies, and E takes possession of the property as reversioner.
9. R conveys a life estate to daughter C for as long as she lives, and then to son D. Who is D, and what does he own?
   A. remainderman, present estate
   B. remainderman, future estate
   C. reversioner, present estate
   D. reversioner, future estate

10. Of these, which estate is NOT inheritable?
    A. fee simple absolute
    B. fee simple defeasible
    C. life estate pur autre vie
    D. ordinary life estate

11. L leases his property to S. L is the ________, and S is the ________.
    A. landlord / lessor
    B. lessee / lessor
    C. lessor / lessee
    D. tenant / landlord

12. A leasehold estate is
    A. personal property.
    B. real property.
    C. both personal property and real property.
    D. neither personal property nor real property.

13. Lessors have a(n) __________ interest in real property.
    A. absolute
    B. present
    C. reversionary
    D. temporary

14. N rents her house to D. D has a ________ estate, and N has a ________ estate. If N moves back into the house at the end of the lease, N will have a ________ estate.
    A. leased fee / leasehold / freehold
    B. leased fee / leased fee / leasehold
    C. leasehold / leased fee / freehold
    D. leasehold / leased fee / leasehold

15. A tenant agrees to rent an apartment for six months for $700 a month. At the end of the six months, the lease automatically renews for another six months. What does this situation describe?
    A. estate for years
    B. holdover tenancy
    C. periodic tenancy
    D. tenancy at will

16. W owns two duplexes. When he dies, his four tenants must vacate the premises. What kind of estate does this indicate?
    A. periodic tenancy
    B. tenancy at sufferance
    C. tenancy at will
    D. tenancy for years

17. M’s lease expired, but she continues living in the apartment without her landlord’s permission. This situation is considered a
    A. periodic tenancy.
    B. tenancy at sufferance.
    C. tenancy at will.
    D. tenancy for years.

18. R agrees to rent an apartment from K for three months for $500 a month. He moves in January 1 and moves out March 31 without giving notice. What type of leasehold estate is this?
    A. period tenancy
    B. tenancy at sufferance
    C. tenancy at will
    D. tenancy for years

19. Y’s friend from college moves to town. Y lets her move into his house while she is looking for a job. What type of leasehold estate is this most likely to be?
    A. period tenancy
    B. tenancy at sufferance
    C. tenancy at will
    D. tenancy for years

20. Generally speaking, if a landlord accepts rent from a holdover tenant after the lease expires, what type of tenancy is created?
    A. period tenancy
    B. tenancy at sufferance
    C. tenancy at will
    D. tenancy for years
Possessory and Nonpossessory Interests in Real Property

- Estates
  - Freehold
    - Life Estate
      - Conventional
      - Statutory
        - Ordinary
        - Pur Autre Vie
        - Dower/Curtesy
        - Homestead
  - Leasehold
    - Fee Simple
      - Absolute
      - Defeasible
        - Determinable (possibility of reverter)
        - Condition Susequent (right of re-entry)
    - Tenancy
    - Periodic Tenancy
    - Tenancy at Will
    - Tenancy at Sufferance

Encumbrances

- Financial (Liens)
  - Voluntary
  - Involuntary
    - Mortgage
    - Trust Deed
    - Mechanics
    - Judgment
    - Tax
    - Attachment

- Non-Financial
  - Easements
  - Restrictive Covenants
    - Appurtenant
    - In Gross
Nonpossessory Interests in Real Property

Nonpossessory interests—claims, limitations, liabilities, or charges—that are attached to real estate are also called encumbrances since they encumber or burden a real property owner’s title. This means that someone who holds a non-possessory interest might have a claim or right to the real property but does not actually have the right to possess the property. Two common types of nonpossessory interests discussed in this chapter are easements and liens. Restrictive covenants, which also create nonpossessory encumbrances on land, are discussed in a later chapter.

After reading this chapter, you will be able to:
• Describe ways in which easements can be created and terminated.
• Identify characteristics of different types of liens.

Key Terms
Attachment Lien  Encumbrance  Runs with the Land
Dominant Tenant  General Lien  Servient Tenant
Dominant Tenement  Involuntary Lien  Servient Tenement
Easement  Judgment Lien  Special Assessment
Easement Appurtenant  License  Specific Lien
Easement by Prescription  Lien  Subordination Agreement
Easement in Gross  Lis Pendens  Voluntary Lien
Encroachment  Mechanic’s Lien
Easements

Easements are rights to use another’s real property for a particular purpose. These rights come with various descriptions and limitations:

- They can be public (e.g., for power lines) or private (e.g., for access to a landlocked parcel).
- They can be put into a deed before a transfer of property occurs or created separately as an agreement between the parties.
- They can be affirmative, which allows someone to do something (e.g., cross property to reach property with no road access), or negative, which prevents someone from doing something (e.g., damming a small stream that runs through property if it will deprive property owners downstream of the water).

An easement is generally classified as either an appurtenant easement or an easement in gross.

Appurtenant Easements

Appurtenant easements burden one piece of land for the benefit of another piece of land. The land benefited by an appurtenant easement is called the dominant tenement. “Tenement” is an old legal term that refers to the land and all the rights that accompany it. The land burdened by that easement is the servient tenement. The owner of the dominant tenement and thus, the person who benefits from the easement, is referred to as the dominant tenant. The owner of the servient tenement and thus, the person whose land is burdened by the easement, is referred to as the servient tenant.

For Example

D has an appurtenant easement across neighbor S’s property. The easement permits D to cross S’s land to get to D’s own property. The easement burdens S’s land for the benefit of D’s land. Therefore, D’s land is the dominant tenement, and S’s land is the servient tenement; D is the dominant tenant, and S is the servient tenant.

Recall that the term “appurtenance” refers to a right that goes along with ownership of real property (like water rights or mineral rights). An appurtenant easement belongs to the dominant tenement—it is a right that goes along with ownership of the dominant tenement.

If the dominant tenant transfers the property (by selling, willing, or giving it away), the easement also transfers. Whoever owns the dominant tenement also owns the easement. If the servient tenant transfers the servient tenement, the new owner takes title subject to the burden of the easement. As long as the appurtenant easement is in writing and has been recorded in the public records, it runs with the land—in other words, it benefits and burdens the same two pieces of property, no matter who owns the land.

View Easements

A view easement protects the dominant tenant’s light and air. It is considered a negative appurtenant easement because it prevents the servient tenant from doing something that could impact the dominant land. These easements are most frequently seen in relation to solar panels, view restrictions, and aviation.
With the use of solar panels becoming more common, the right to light is becoming more of an issue. Many states have passed solar easement laws, zoning laws, or building codes geared toward solar issues that require owners to place certain restrictions or covenants in deeds.

Under the statutes of some states, the landowner who first establishes solar panels for power generation has the right to unobstructed and continued use. This means that a neighbor cannot do anything on his property that would interfere with the neighbor's solar panels, such as planting trees or erecting a structure that blocks the light.

**Easements in Gross**

Easements in gross benefit a person only and not a piece of land. Therefore, there is a dominant tenant (person benefiting from the easement), but no dominant tenement (because there is no land benefiting from the easement). And since an easement in gross, like all easements, is a right that burdens another's land, there is still both a servient tenement (land burdened by the easement in gross) and a servient tenant (person owning the land burdened by the easement).

**For Example**

F lives five miles away from G. G grants F an easement in gross to enter G's property and fish in the small lake.

F's easement is not appurtenant to his land. If F sells his property, the new owner does not gain the right to fish on G's land. The easement belongs to F personally, wherever he lives. But the easement in gross does run with G's land: if G sells his land to someone else, F still has the right to fish in the lake.

An easement in gross belonging to an individual (like F's right to fish in the previous example) is called a personal easement in gross. Someone who holds a personal easement in gross cannot assign it to someone else and it is extinguished when the easement holder dies.

Most easements in gross belong to commercial enterprises rather than individuals. For example, a utility company has an easement right that allows its employees to enter private property to install and service lines. Unlike a personal easement in gross, a commercial easement in gross can be assigned.
Creation of Easements

Easements can be created in a number of ways; either voluntarily or involuntarily. In addition to the creation of easements through the agreement of the parties involved, there are also several ways to establish easements by operation of law.

Easements by Express Reservation

Easements by express reservation occur when a landowner divides property and includes language in the deed that transfers a servient tenement to the buyer, but retains a dominant tenement for himself. Thus, the seller keeps an easement across his former property.

For Example

X owns a large tract of land and sells part of it to Z. In the deed, X might reserve the right to cross Z’s parcel to reach his own land. This easement by express reservation makes X’s land the dominant tenement, and Z’s land is subservient.

Easements by Express Grant

Easements by express grant are created in a deed or other document. Here, the easement can be granted in the original deed or at a future date, and either party may request the easement. Thus, the original deed might state that Z has the right to cross X’s land to reach Z’s parcel. Or, the easement might be conveyed later in a separate document that conveys only the easement. For example, several years after Z bought her parcel from X, Z might ask X to grant Z an easement across X’s land.

Because they involve the transfer of an interest in real property, in most states, easements created by express reservation or express grant must be in writing to be valid—oral agreements are not enough.

For Example

D and S are neighbors. D asks S for an access easement allowing D to cross S’s property. S agrees, but the easement agreement is never put in writing. Six months later, S changes his mind and tells D to keep off his land. D cannot enforce her easement right because it was only an oral agreement.

But, suppose S signed a document granting D the easement. Now, if S changes his mind, D has an enforceable right.

Generally, both parties should sign a document granting an easement just like a deed and record it to make sure anyone who buys the servient tenement has notice of the easement. If the purchaser does not have notice, the easement probably will not run with the land.

Easements by Implication

Easements by implication are easements created by operation of law when a parcel of land is divided if there is a long-standing, apparent use that is reasonably necessary for the enjoyment of the dominant tenement. This is also called an implied easement.
Generally, implied easements arise when a tract of land was originally held by one owner, then divided into two or more parcels. The original owner would keep an ingress or egress—a means onto or off of the land. At the time of the division, the use giving rise to the easement must have been in place for a long time and must be apparent from a visual inspection of the property. The use must also be reasonably necessary for the enjoyment of the dominant tenement.

**For Example**

T owned a large piece of land with a long driveway leading from the main road to her house. T sold the south half of her land (the part beside the main road) to Y and kept the north half (the part with her house on it).

T did not reserve an easement for herself in the deed to Y. Although she could reach her property by a winding back road, the driveway across Y’s parcel was much more direct, so T just continued using the driveway as she always had. Y filed a lawsuit to prevent T from using it.

The court ruled that T had an easement by implication across Y’s parcel. T’s use of the driveway was obvious and well-established when the land was divided. Although the driveway was not the only access to T’s parcel, it was reasonably necessary for the enjoyment of her property.

**Easements by Necessity**

Easements by necessity are special easements by implication that occur when a piece of property would be completely useless without an easement against another property, even if there is not a long-standing, apparent use. In such a case, a court will hold that there is an easement by necessity. The claimant does not have to prove the use was long-established and obvious at the time of the sale but must prove the easement is strictly necessary (not just reasonably necessary) for use of the land. A person cannot claim an easement by necessity when there is another way to his property, even if that alternative route is much less convenient than the easement route.

**Easements by Prescription**

Easements by prescription occur when someone uses servient land in a specific way for a statutory length of time. Three conditions create an easement by prescription:

1. **Open and notorious use of the land:** Use must be obvious and unconcealed so that if the landowner keeps reasonably well informed about the property, he is aware of the use.

2. **Hostile and adverse use of the land:** Use is without the permission of the owner and against the owner’s interests. If the owner gives permission, an easement cannot develop by prescription.

3. **Continuous use for the statutory number of years:** Each state mandates a specific number of years of use before someone can claim an easement by prescription. Some states do not require the use to be constant; it can be just regular use—normal for the type of property in question. Some states also do not require the user to be the same person. If the property is used in the same way by two or more people in succession, their periods of use can be added together to equal the required number of years. This is called tacking.
For Example

D and S own adjoining property in a state that requires 21 years of continuous use to claim an easement by prescription. For 10 years, D drives across a corner of S's property without S's permission. Then, D sells his property to M. For another six years M drives across the same corner. Then M sells to J. J drives across S's property for another five years. Now J can claim an easement by prescription. Added together, D's 10 years, M's six years, and J's five years make up the necessary 21 years of continuous use.

The requirements for prescription are similar to those for adverse possession of property (explained in a later chapter). Adverse possession results in a transfer of ownership, however, not just the creation of an easement. Also, note that an easement by prescription can never be acquired against government property.

Termination of Easements

An easement can be terminated in several ways—some voluntary, some involuntary. There are also ways to terminate an easement through the operation of law.

**RELEASE** A release is a document in which a legal right is given up and, in this case, a document that relinquishes the easement holder's interest in the servient tenement. The easement holder may be willing to give up the easement with or without compensation. An easement release should always be recorded.

**MERGER** Merger is the uniting of two or more separate properties by transferring ownership of them. When one person becomes the owner of both the dominant tenement and the servient tenement, the easement is extinguished by merger. A person cannot have an easement on his own property since an easement is defined as an interest in another's land. Even if the owner later divides and sells all or part of the property, the easement no longer exists and must be recreated, if desired.

**ABANDONMENT** Abandonment is the failure to occupy and use property, which may result in a loss of rights. An easement ceases to exist if the owner abandons it. Non-use alone, however, is not enough for abandonment. There must be an act or statement that clearly expresses the owner's intention to abandon the easement.

**PRESCRIPTION** An easement can be terminated after the statutory number of years of non-use. Just as easements can be created by prescription, an easement can be terminated by prescription. If the dominant tenant ceases to use the easement for the required number of years, the easement is lost by prescription.

**DESTRUCTION** The involuntary destruction (e.g., fire) of a building would end an easement that allows the dominant tenant to use the building. If the owner rebuilds the building, the easement does not automatically revive.

**FAILURE OF PURPOSE** An easement terminates when the purpose for which it was created no longer exists (e.g., an electric company's easement for power lines across a farmer's property would end if the company removed the lines).
Easements versus Licenses

A license is a revocable, non-assignable permission to enter another person's land for a particular purpose; thus, a license is similar to an easement in that it grants permission to use another's property. However, unlike an easement, a license does not create an interest in the property and is not considered an encumbrance.

Here are a few more differences between licenses and easements:

- Easements are normally for an indefinite period of time; licenses are usually temporary.
- Easements are created by written agreement or by an action of law (implication or prescription); licenses may be created by oral agreement.
- Easements generally run with the land; licenses do not have to but can if the licensee has to pay to make the license usable.

Perhaps the most important distinction is that an easement cannot be revoked, whereas a license, usually, can be revoked at any time. However, if the licensee makes a substantial financial commitment to use the license, the financial commitment may limit the licensor's power to revoke it. A court may allow the licensee to continue using the licensor's property long enough to get a fair return from his expenditures.

Also, like a personal easement in gross, a license cannot be assigned. It becomes invalid if the licensee dies.

Easements and Encroachments

An encroachment is a physical object intruding onto a neighbor's property (e.g., a tool shed that is two feet over the property line, a tree branch growing over a fence). Although most encroachments are unintentional, the law sees them as a form of trespassing. If a neighbor sues, the court can order an encroachment removed; if removal is unfeasible, the encroacher may be ordered to pay damages.

An encroachment is not an encumbrance because it is not a right or interest held by the encroacher. Sometimes, though, the encroacher will purchase an easement from the neighbor, allowing the encroachment to continue. If the neighbor ignores an encroachment for the statutory number of years, it could ripen into easement by prescription.

Liens

Liens, also called financial encumbrances, are nonpossessory financial interests in property. A lien provides security for a debt, giving the creditor (lienholder) the right to foreclose on the debtor's property if the debt is not paid. Foreclosure occurs when a lienholder causes property to be sold so unpaid debt secured by the lien can be satisfied from the sale proceeds.

Lien Classification

Liens may be classified in a number of ways.

Voluntary or Involuntary

Voluntary liens are placed against property with the consent of the owner. The most common form of a voluntary lien is a mortgage or trust deed.
Involuntary liens arise by operation of law without the consent of the property owner. These liens are also created to protect a property owner's creditors. An involuntary lien may further be described as either statutory, meaning it was created by legislation or rule, or equitable, meaning it was created by order of a court.

**General or Specific**

Liens can be further classified as general or specific:

- A general lien attaches to all property owned in the county by the debtor.
- A specific lien attaches to specific property.

**Types of Liens**

Liens can be placed against property for a variety of reasons.

**Mortgage Liens**

Mortgages are written instruments that use specific real property to secure payment of a debt. Without a debt, there can be no mortgage. The debt is created by a note or promissory note, which is a written, legally binding promise to repay a debt. The note creates the debt, and the mortgage secures the payment. The lender holds only a lien against the property, not actual title, until the loan is repaid. Mortgages, and other home equity loans, create a voluntary, specific lien that is a powerful incentive for an owner to pay. It allows the lender to potentially take ownership of the property through foreclosure proceedings if a person defaults on the mortgage by failing to make payments.

**Vendor’s Liens**

Vendor’s liens are involuntary, specific liens that secure payment of the balance of the purchase price of a piece of real estate, if a real estate buyer does not pay the seller in full at closing. In such a case, the seller automatically has a lien against the property for the balance of the purchase price. It is called a vendor's lien because “vendor” is another term for seller and the two terms are interchangeable. A vendor’s lien does not attach to the property, however, if the seller accepts a mortgage from the buyer for the amount owed.

When property is subject to a vendor's lien, the seller should state that in the deed (or another recorded document). Otherwise, the lien would be effective only against the buyer—not against third parties. If the buyer sells the property to someone else, the vendor's lien of the original seller will be void.

**Mechanic’s Liens**

Mechanic’s liens are involuntary, specific liens claimed by someone who performed work on real property—such as construction, remodeling, repairs, or demolition—and has not been paid. In such a case, the property serves as security for payment of the labor and material costs. Each person who works on a project, or supplies materials for it, can obtain a mechanic's lien. If the owner does not pay the bills, the holder of a mechanic’s lien can force the sale of the property and collect the debt from the sale proceeds.
In legal terms, anyone who performs labor on real property is a mechanic (e.g., landscaper, builder, subcontractor). Anyone who supplies building materials, machinery, or fuel for a project is a materialman (e.g., trucking or lumber company). A materialman’s lien is usually referred to, and treated the same, as a mechanic’s lien.

Most states have specific statutes that address the use of mechanic’s liens, such as timeframes and requirements for filing. Because they are statutory, these liens must be prepared as required in the statute to be enforceable.

**Tax Liens**

**Tax liens** are *liens on real property to secure the payment of various taxes.*

**PROPERTY TAX LIENS** Counties, cities, and certain non-political entities (such as school districts and utility districts) raise revenue by taxing real property **according to its value**, known as **ad valorem** taxes. Ad valorem taxes create an **involuntary, specific** lien against the property. Each state has specific statutes that address the timing for attaching real property tax liens and the terms under which the property can be foreclosed on if payment is delinquent.

**SPECIAL ASSESSMENT LIENS** Special assessments are *taxes used to pay for public improvements (e.g., paving roads, installing sewer lines) in a particular neighborhood.* Property owners who benefit from an improvement are required to pay their share of its cost. Special assessments also create an **involuntary, specific** lien against the owners’ properties.

**INCOME TAX LIENS** Unpaid federal income taxes create another type of tax lien. When payment is overdue, liens attach to all of the taxpayer’s personal and real property. Income tax liens are **involuntary, general** liens.

**Judgment Liens**

**Judgment liens** are *liens that attach to a person’s property as a result of a court action.* At the end of a civil lawsuit, if the judge or jury determines that one party owes money to the other, a judgment is entered against the losing party. The winner (the **judgment creditor**) may claim a lien against the loser’s (the **judgment debtor’s**) real property. Judgment liens are **involuntary, general** liens.

Each state has statutes that address how judgment liens may be attached. Generally speaking, to claim a lien, the judgment creditor obtains a **certificate of judgment** from the clerk of the court that issued the judgment. The creditor then files the certificate in the counties where the judgment debtor owns real property, attaching the judgment lien to all of the debtor’s real property in those jurisdictions.

**CONFESSION OF JUDGMENT** Judgment liens that are created by a **confession of judgment** are **voluntary, general** liens. A confession of judgment is filed when someone who owes money **permits a judgment to be entered against him or her by written statement without any legal proceedings.**

**Attachment Liens**

**Attachment liens** are *liens intended to prevent the transfer of property, pending the outcome of litigation.* When a plaintiff files a lawsuit there is a danger that, by the time a judgment is entered, the defendant will have sold all of his property and left the jurisdiction. That would make the plaintiff’s judgment a worthless piece of paper.
To prevent this, at the outset of a lawsuit, the plaintiff can ask the court to issue an **order of attachment**. The order directs the sheriff to seize enough of the defendant's property to satisfy the judgment the plaintiff is seeking. In the case of personal property, this may involve an actual physical seizure. For real property, the order simply creates an involuntary lien, called a **lis pendens**, which is a recorded notice stating **there is a lawsuit pending that may affect title to the defendant's property**.

**Broker Lien Laws**

Many states have statutes that allow a **licensed real estate broker** who enters into a written contract for services related to selling, leasing, or conveying any interest in real estate to file a lien against that real estate for nonpayment of services. In many states, broker liens are a remedy only for commercial property. Generally, such liens are effective only against the interest in real estate that is the subject of the contract, making them **involuntary, specific** liens.

<table>
<thead>
<tr>
<th>Type of Lien</th>
<th>Voluntary</th>
<th>Involuntary</th>
<th>General</th>
<th>Specific</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage Lien</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property Tax Lien</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vendor's Lien</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IRS Tax Lien</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mechanic's or Materialman's Lien</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Judgement Lien (court decree)</td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Judgment Lien (confession of judgment)</td>
<td></td>
<td></td>
<td>X</td>
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</tr>
<tr>
<td>Attachment Lien</td>
<td></td>
<td>X</td>
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</tr>
<tr>
<td>Broker Lien</td>
<td>X</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

4.2 **Classification of Liens**

**Lien Priority**

It is not unusual for property to have several liens against it at the same time, for example, a mortgage, a mechanic's lien, and an ad valorem property tax lien. If the owner defaults on the debt obligations and a lienholder forecloses, the total amount of the liens may be more than the property will bring at a forced sale. If all liens cannot be paid in full, there is an established order of priority for paying the lienholders.

**Superior** liens take precedence over all other types of liens after a foreclosure sale and are paid before any junior lien. A lien for **delinquent ad valorem property taxes is superior to all other liens** against the property, even liens that were attached earlier. This is why many lenders require borrowers to add property tax payments to their monthly mortgage obligation. The lender maintains the funds in an escrow account and pays the property taxes on behalf of the borrower, protecting the lender's lien position in case of borrower default.

After the superior liens are satisfied, any remaining money from the property sale pays the **junior liens generally in the order they were attached** to the land.

There are some exceptions to this:

- A **vendor's lien** generally attaches automatically as soon as **title to the land is transferred**. However, the lien will lose its priority unless the deed or other recorded document stated the property was subject to a vendor's lien (giving notice to other lien claimants).
• In many states, a **mechanic's lien** attaches as of the day the contract for work was signed, the day the work begins, or the day that materials were delivered, not the date the lien was filed. If the lien is not handled exactly as required by statute, however, the lien will be lost.

If a forced sale brings enough to pay off only the superior lien (or part of it), the other lienholders will receive nothing. If there is enough to pay off only the superior lien and the first junior, the rest will receive nothing, and so forth.

**Homestead Laws**

Many states have **homestead laws** that give owner-occupied residences some protection from lien foreclosure. A certain amount of the homeowner's equity in the property is exempt from foreclosure. This means if a lienholder forecloses, the exemption amount will be set aside for the homeowner out of the sale proceeds—even if there is not enough left to pay off all the liens.

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**Challenge Activity**

*Consider the following scenario, then complete the table to reflect each event.*

H and J buy a house on October 1, taking out a mortgage (A) with ABC Bank for $210,000. On October 2, they hire B, a general contractor, to renovate the kitchen before they moved into the house. On October 3, the title company records the mortgage. H and J live in the house for only two months when J loses his job. They quit paying their mortgage and property taxes (B) and never pay their outstanding bill of $24,800 to contractor B, who files a lien (C). The following June, the IRS files a lien against J for unpaid income taxes (D). ABC Bank forecloses on the house. When they do not recover the amount of the mortgage from the sale, ABC sues H and J and wins a deficiency judgment in court (E).

<table>
<thead>
<tr>
<th>Type of Lien</th>
<th>Voluntary or Involuntary</th>
<th>General or Specific</th>
<th>Order of Payment at Foreclosure</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A)</td>
<td>V I</td>
<td>G S</td>
<td></td>
</tr>
<tr>
<td>(B)</td>
<td>V I</td>
<td>G S</td>
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</tr>
<tr>
<td>(C)</td>
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</tr>
<tr>
<td>(D)</td>
<td>V I</td>
<td>G S</td>
<td></td>
</tr>
<tr>
<td>(E)</td>
<td>V I</td>
<td>G S</td>
<td></td>
</tr>
</tbody>
</table>
Clearing Liens at Closing

The fact that there are liens against a property does not prevent its transfer, but transfer will not eliminate the liens. A buyer could choose to take the property subject to the liens, for example, by assuming the mortgage. In such a case, the buyer takes the property and must continue to pay the lien to keep the property. In most real estate transactions, however, the seller is required to clear the title of liens before closing by paying off the underlying debts. There are a number of ways the debtor can do this:

- The necessary funds could be withheld at settlement to pay off the debt. A record of satisfaction of the lien should be recorded in the public records to protect the new owner.
- If the seller owes more on the property than the sale of it will generate, the seller might have to come to the settlement table with a check to discharge the additional debt.
- If it's a general lien against the property owner, the creditor could agree to release the property that's being sold if the debtor has other personal or real property that can be used as collateral.

Summary

1. **Easements** are the right to use another's property for a particular purpose. Easements are nonpossessory interests (encumbrances) that are **appurtenant** or **in gross**. Appurtenant easements burden one piece of land for the benefit of another piece of land. Easements in gross benefit a person, not a piece of land. Easements are created by **express grant**, **express reservation**, **implied**, **necessity**, or **prescription**. Easements are terminated by **release**, **merger**, **abandonment**, **prescription**, **destruction**, or **failure of purpose**. Easements are normally in effect for an indefinite period of time, created by written agreement or action of law, cannot be revoked, and generally run with the land if property written and filed in the public records. Easements are a huge source of litigation.

2. **Licenses** are revocable, non-assignable permission to enter a person's land for a particular purpose. Licenses are often temporary and can be verbal. Licenses do not run with the land unless the licensee has to pay to make the license usable.

3. **Liens** are nonpossessory interests, which are financial encumbrances. Lienholders can **foreclose** on property in the event of default, forcing it to be sold so unpaid debt can be paid from the sale proceeds. The most common liens are **mortgages**, **tax liens**, **mechanics’ liens**, and **judgment liens**.

4. Most liens are prioritized (and thus paid out in foreclosure) in the order they are recorded, but ad valorem property tax liens always have priority, unlike income tax liens whose priority is based on when they were filed. Lower priority liens may get nothing from a foreclosure sale.
Chapter Quiz

1. The gas company has an easement in gross to access its gas lines on the
   A. dominant tenant.
   B. dominant tenement.
   C. servient tenant.
   D. servient tenement.

2. L has lived in a house on the lot behind T’s property for 30 years, driving across T’s vacant front property to get to the road without an easement. When T finally decides to build, she puts a fence all around her property, blocking L from the road. Other than an easement by necessity, what option might L have to travel from her property to the road?
   A. easement by condemnation
   B. easement by implication
   C. easement by prescription
   D. She has no other option.

3. E and K have an agreement that E is permitted to hunt on K’s property during the current hunting season. This agreement is a(n)
   A. encroachment.
   B. encumbrance.
   C. license.
   D. public easement.

4. B has an appurtenant easement that allows him to cross over his neighbor’s land to get to the lake. When the neighbor sells this land to B, the easement is terminated through
   A. abandonment.
   B. destruction.
   C. failure of purpose.
   D. merger.

5. Which situation would LEAST likely be an example of a license?
   A. D buys a ticket to the theater.
   B. N gives J the right to hunt on his property.
   C. R gets access to cross his neighbor’s lawn to get to the lake when he bought his house.
   D. T checks into a hotel for two nights.

6. W has an easement to drive across his neighbor V’s property to get to his barn. W’s property is known as the ____________ tenement.
   A. affirmative
   B. appurtenant
   C. dominant
   D. servient

7. A similarity between an easement and a license is that both
   A. can be revoked at any time.
   B. create an encumbrance.
   C. grant someone access to another’s property.
   D. run with the land.

8. A thunderstorm knocks down power lines on J’s property. Big City Electric enters J’s property without his permission to fix the lines. This is an example of
   A. easement appurtenant.
   B. easement in gross.
   C. encroachment.
   D. trespassing.

9. R buys a house near the beach. After he moves in, R and his neighbor sign a written agreement that allows R to cross the neighbor’s property to get to the beach. The agreement states that if R moves or dies, the permission is terminated. What is this an example of?
   A. appurtenant easement
   B. easement in gross
   C. life estate
   D. voluntary lien

10. Which is an example of a negative easement?
    A. The gas company uses two feet in front of A’s house for lines.
    B. B and neighbor C share a wall separating their gardens.
    C. D’s neighbor goes to court to get the right to drive across D’s land to get to his.
    D. G’s neighbor is unable to add a second story to his house if it blocks G’s sunlight.
11. Which is NOT a requirement to claim an easement by prescription?
A. adverse use  
B. exclusive use  
C. hostile use  
D. notorious use

12. Which statement about liens is FALSE?
A. A lien does not prevent the transfer of property.  
B. A lien is a financial encumbrance.  
C. A lien is a possessory interest.  
D. A lien may be placed against personal property.

13. Which is an involuntary, specific lien?
A. easement created by express agreement  
B. judgment lien  
C. mechanic's lien  
D. mortgage

14. Which type of lien can be either voluntary or involuntary?
A. income tax lien  
B. judgment lien  
C. mechanic's lien  
D. property tax lien

15. All of the following are examples of junior liens EXCEPT
A. attachment liens.  
B. judgment liens.  
C. mechanic's liens.  
D. property tax liens.

16. All of the following are examples of specific liens EXCEPT
A. judgment liens.  
B. mechanic's liens.  
C. property tax liens.  
D. special assessments.

17. When a firm is not paid after furnishing material for the construction of an apartment building, the firm may file a(n)
A. deficiency judgment.  
B. estoppel certificate.  
C. lis pendens.  
D. mechanic's lien.

18. Which project would LEAST LIKELY justify a special assessment?
A. new curbs on Oak Street  
B. new driveway approaches in the River Bend subdivision  
C. new siding on an individual property owner's home  
D. ornamental street lighting in the historic district

19. When G purchases a house, he gets a mortgage. The mortgage is recorded May 1. G builds a deck in July and then goes to Hawaii for several months. He doesn't pay any of his bills and his property goes into foreclosure. Generally speaking, in what order will the liens be paid?
A. mechanic's lien, property tax lien, mortgage lien  
B. mortgage lien, mechanic's lien, property tax lien  
C. mortgage lien, property tax lien, mechanic's lien  
D. property tax lien, mortgage lien, mechanic's lien

20. Which is the best example of an involuntary, general lien?
A. IRS tax lien  
B. mechanic's lien  
C. mortgage lien  
D. special assessment lien
Forms of Ownership

The United States practices what is perhaps the most free and flexible form of real property ownership, known as the allodial system, which allows title to land to be vested in individuals. While not a pure allodial system, since the government retains certain interests in privately owned land, ownership does bring with it certain rights. This chapter discusses those rights, as well as different types of ownership—sole and concurrent. Remember as we look at these forms of ownership that someone can sell all of what they own, part of what they own, but never more than what they own.

After reading this chapter, you will be able to:

• Compare and contrast different forms of ownership.
• Identify different types of common interest ownership.
• Distinguish condominium ownership from cooperative and other alternative ownership.

Key Terms

Common Areas  Limited Common Areas  Tenancy in Common
Community Property  Marital Property  Trust
Condominium  Nonmarital Property  Undivided Interest
Co-Ownership  Ownership in Severalty  Unity of Interest
Cooperative  Proprietary Lease  Unity of Person
Corporation  Right of Survivorship  Unity of Possession
Joint Tenancy  Sole Proprietorship  Unity of Time
Land Trust  Tenancy by Entirety  Unity of Title
Property Ownership

Ownership—or title to property—is most often created and conveyed by:

- **Deed**, such as when someone *sells* a house to someone else.
- **Devise**, such as when real property is transferred after the owner’s death under provisions of a *will*.
- **Descent**, such as when someone dies without a will and the state’s statute of descent determines who owns the real property.

There are two primary forms of ownership:

- **Ownership in severalty**, where *one person or entity* holds title to property.
- **Concurrent ownership**, where *two or more persons or entities* hold title to property.

Ownership in Severalty

Ownership in severalty, also known as *tenancy in severalty* or *several ownership*, is the simplest form of ownership. It is a sole form of ownership, meaning that only one person or legal entity—such as a corporation—holds the title to that property.

Don’t be confused about the word *severalty*. It might sound as though it implies “several” people, but it really means that one owner’s interest has been *severed from the interests of all others*.

Concurrent Ownership

Co-ownership by individuals, also known as *concurrent ownership* or *co-tenancy*, is *any form of ownership where two or more persons share title to real property*, with each person having an undivided interest in the property. *Undivided interest gives each co-owner the right to possess the whole property, not just part of it.*

Under the law, any number of persons may join in the ownership of real property, but the relationship these people share depends on the deed language, which is evidence of their right to title to the land.

Unities of Co-Ownership

The presence of several conditions, known as *unities*, defines the form of co-ownership:

- **Unity of possession.** All co-owners hold the same undivided right to possess the whole property (as opposed to a designated portion of that property).
- **Unity of interest.** All co-owners hold equal ownership interests.
- **Unity of time.** All co-owners acquired their interests at the same time.
- **Unity of title.** All co-owners acquired their interests by the same deed or will.

A fifth unity may also be considered—the *unity of person*, which means *that all co-owners are a single, indivisible legal unit*. This unity applies to legal spouses and, in some states, to partners in a legal civil union.
Forms of Co-Ownership

Generally speaking, there are three forms of co-ownership:

- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Key distinguishing factors include the presence of the unities, the method in which the ownership interest is created, as well as the method by which ownership is passed, including the right of survivorship, which means the property passes automatically to other co-owners when one co-owner dies.

Tenancy in Common

Tenancy in common is a form of co-ownership with two or more persons having an undivided interest in the entire land, but no right of survivorship. When a tenant in common dies, his interest in the property passes to his heirs. Tenancy in common is the most common form of co-ownership and the only co-ownership that can be owned in unequal fractional portions.

A key concept in a tenancy in common is the unity of possession, which means each co-owner is entitled to possession of the entire property because the ownership interests are undivided. Each tenant in common, no matter what fractional interest he holds, has a right to possess the whole property. This means there are no boundary lines within the property itself separating the co-tenants’ interests from each other. All co-tenants under tenancy in common enjoy the unity of possession.

Both deed and devise can create and convey a tenancy in common.

For Example

A, B, C, and D are co-owners of a property. Any of the co-owners, also called tenants in common, can sell his or her share of the interest—the whole share or just part of it—to someone else. So, co-owners have the right of disposal. When Tenant in Common A dies, that 35% share goes to A’s heirs, not to co-owners C and E.

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Original ownership</td>
<td>35%</td>
<td>20%</td>
<td>30%</td>
<td>15%</td>
<td>--</td>
</tr>
<tr>
<td>2. D sells his share to E</td>
<td>35%</td>
<td>20%</td>
<td>30%</td>
<td>--</td>
<td>15%</td>
</tr>
<tr>
<td>3. B sells his share to C</td>
<td>35%</td>
<td>--</td>
<td>50%</td>
<td>--</td>
<td>15%</td>
</tr>
</tbody>
</table>

Each tenant in common:

- Has the right to share proportionately in the profits of the property, whether those profits are generated through the use of the property itself (e.g., farming, mining) or through leasing the property to another.
- Has, in proportion to their share of ownership, the burden of maintaining the property (paying taxes and other expenses incident to property ownership).
- Must not commit waste to the property or he will be responsible for reimbursing the innocent tenants for the damage.
A tenant in common is free to transfer ownership of his or her interest at any time without the consent of the other co-tenants. However, to sell the entire parcel, or to encumber the property with a mortgage, all tenants in common must sign the deed, note, or mortgage.

**Joint Tenancy**

Joint tenancy exists when *each co-owner has an equal undivided interest in the land and right of survivorship*. Joint tenancy requires the *four unities* of possession, interest, time, and title. To establish a joint tenancy, joint tenant owners take ownership *equally and simultaneously*.

The main feature of joint tenancy is that it allows co-owners to receive the ownership shares of a deceased co-owner automatically. Because joint tenancy has the right of *survivorship*, when one joint tenant dies, the surviving members of the joint tenancy receive deceased person’s share, again, equally and simultaneously.

### For Example

Joint tenants A, B, C, D, and E own a property. As each joint tenant dies, the other surviving joint tenants absorb the percentage of ownership from the deceased. The last remaining joint tenant owns the property in severalty.

<table>
<thead>
<tr>
<th></th>
<th>Joint Tenant A</th>
<th>Joint Tenant B</th>
<th>Joint Tenant C</th>
<th>Joint Tenant D</th>
<th>Joint Tenant E</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Original ownership</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>2. E dies</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
<td>--</td>
</tr>
<tr>
<td>3. D dies</td>
<td>33 1/3%</td>
<td>33 1/3%</td>
<td>33 1/3%</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>4. C dies</td>
<td>50%</td>
<td>50%</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>5. B dies</td>
<td>100%</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
</tbody>
</table>

Generally, joint tenancy assumes the right of survivorship. In some states, however, the creation of joint tenancy with right of survivorship *must* be explicitly stated in the deed, for example: “J and S, as joint tenants with right of survivorship and not as tenants in common...” The right of survivorship is not necessarily assumed.

A joint tenant *cannot will ownership* to another; only a *deed* can convey joint tenancy. When a joint tenant conveys his interest through a *deed*, the new co-owner is a *tenant in common* in relation to the other co-owners, and any right of survivorship in that specific interest ends.
For Example

Joint tenants A, B, and C own a property. When C sells his interest to D, D takes ownership as a tenant in common (having only the unity of possession).

<table>
<thead>
<tr>
<th></th>
<th>Joint Tenant A</th>
<th>Joint Tenant B</th>
<th>Joint Tenant C</th>
<th>Tenant in Common D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Original ownership</td>
<td>33 1/3%</td>
<td>33 1/3%</td>
<td>33 1/3%</td>
<td>--</td>
</tr>
<tr>
<td>2. C sells interest to D</td>
<td>33 1/3%</td>
<td>33 1/3%</td>
<td>--</td>
<td>33 1/3%</td>
</tr>
<tr>
<td>3. B dies</td>
<td>66 2/3%</td>
<td>--</td>
<td>--</td>
<td>33 1/3%</td>
</tr>
<tr>
<td>4. D dies</td>
<td>66 2/3%</td>
<td>--</td>
<td>--</td>
<td>33 1/3% to D's heirs</td>
</tr>
</tbody>
</table>

THE RIGHT OF PARTITION Parties to a joint tenancy or a tenancy in common have the right of partition, which allows any co-owner to end the co-ownership. A voluntary partition can be implemented where all parties agree to end the joint venture and divide the property so each owns a piece in severalty if it can be done equitably. Or, one owner can sue the other(s) through a judicial process to dissolve the co-ownership and divide the property or sell it and divide the proceeds according to the judgment of the courts.

Tenancy by the Entirety

Tenancy by the entirety is a form of co-ownership recognized in some states that involves only owners who are legal spouses or partners with each having an equal and undivided share of the property. This form of ownership includes the right of survivorship, with property automatically going to the surviving spouse or legal partner. Tenancy by the entirety requires all five unities—possession, interest, time, title, and person—since spouses and legal partners are considered a single, indivisible, legal person.

This type of ownership can be terminated if:

- One spouse or partner dies, at which point the surviving spouse or partner becomes the owner in severalty without going through probate.
- Both parties agree to end this type of ownership and both sign a new deed.
- The couple gets divorced but keeps the property, at which point they own the property as tenants in common.
### 5.1 Forms of Co-Ownership

<table>
<thead>
<tr>
<th>Unities</th>
<th>Tenancy in Common</th>
<th>Joint Tenancy</th>
<th>Tenancy by the Entirety</th>
</tr>
</thead>
<tbody>
<tr>
<td>Possession</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Interest</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Time</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Title</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Person</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Created by…</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deed</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Devise</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Law</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disposed of by…</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deed</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Devise</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Descent</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Right of Survivorship</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Disposable Interest</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

### Marital and Nonmarital Property

In some states, a person who is part of a married couple can own property independently of his or her marital status, assuming only he or she holds the title. **Separate property**, also known as **nonmarital property**, may be property that was:

- Owned prior to the marriage or legal civil union, or
- Given or devised by will only to one spouse or partner during the term of the marriage or civil union.

If either party otherwise acquires property during the marriage or civil union, it is generally considered to be **marital property**, regardless of whether one or both individuals hold title. Such property is considered to be joint property as long as the marriage exists.

Other states recognize **community property** law, which says that two people in a marriage are **equal but separate** partners. Each spouse equally owns any property—real or personal—they acquire during the marriage. In the event of a divorce, they must divide the property equally.
Ownership by Association

Business organizations, non-profit groups, and other entities may own property in severalty or as alternate forms of co-ownership. Depending on its form, an association may be:

- A legal entity separate from its individual members or owners (e.g., a corporation where the shareholders own property in severalty as the corporation).
- Informal (e.g., a general partnership where the partners co-own the property).

Title to property can be held in a business name.

Corporations

A corporation is a legal entity in which individuals hold ownership shares of stock. A corporation is regarded by the law as an artificial person, separate from the individual stockholders. A corporation is the most sophisticated form of association. To establish a corporation in most states, the organizers (incorporators) must file articles of incorporation with a state agency, such as the Secretary of State’s Office.

A corporation is owned by shareholders, individuals who purchase shares of stock in the company as an investment. Since the law treats the corporation as an artificial individual, it can enter contracts, incur debts, sue and be sued, and own property. When a corporation owns property, it owns it in severalty, just like a natural person. The shareholders do not own the corporation’s property, and they are not personally liable for the corporation’s debts. A shareholder’s spouse has no dower rights in property the corporation owns. This is true even when a married person is the corporation’s sole shareholder.

A board of directors manages the corporation. The board appoints corporate officers to run the business on a day-to-day basis. In most cases, the officers are not automatically authorized to convey or encumber the corporation’s real property. A resolution of the board is required to expressly authorize such actions.

The chief drawback to a corporation is the potential for double taxation. With a standard C corporation, the corporation first pays corporate income taxes on its profits. Then, if the corporation distributes profits to shareholders as dividends, the government taxes the same money again as the shareholders’ personal income. Some states recognize a subchapter S corporation that provides special tax benefits to address the issue of double-taxation. Of course, real estate licensees should advise clients to seek legal counsel concerning the operation of corporations.

Partnerships

A partnership is an association of two or more individuals as co-owners of a business, as specified in a partnership agreement. Each partner contributes money, property, skill, or labor with the expectation of the sharing in the profits and losses of the business. The partners can agree to terminate the partnership at any time. Partnerships may also terminate upon the death or bankruptcy of a partner.

There are two main types of partnerships, general and limited.
General Partnership

A general partnership is simply an association of two or more individuals as co-owners of a business run for profit. It does not have to be formally organized like a corporation. A group of people running a business may be a partnership without even realizing it.

For most purposes, the law does not recognize a general partnership as an entity independent from the individual partners. Unlike corporate shareholders, general partners have unlimited liability for the acts of the partnership. Each partner can be made to pay the partnership's debts out of his own pocket. The partners have to pay taxes on the income they receive from the business, but the partnership itself does not pay taxes.

Limited Partnerships

A limited partnership, like a general partnership, is an association of two or more persons as co-owners of a business. A limited partnership differs from a general partnership in that a limited partnership has one or more general partners, plus one or more limited partners. The rights and duties of general partners in a limited partnership are the same as in a general partnership. The limited partners, however, have limited liability for partnership debts and a limited role in the management of the business.

A limited partnership combines some advantages of a corporation with some advantages of a general partnership. Limited partners are protected from liability (e.g., the government taxes profits only once as partners' personal income).

Partnership Property

All property that general partners bring into the business at the outset, and all that they later acquire for the business, is partnership property. Anything purchased with partnership funds is also presumed to be partnership property. The partners own the partnership property as tenants in partnership, a form of co-ownership, giving each partner an equal, undivided interest in the property. Each partner has an equal right to possess the partnership property for partnership purposes—that is, in carrying on the partnership’s business. They do not, however, have the right to possess the property for any other purpose, without the other partners' consent.

Note that partnership laws vary from state to state. For example, in some states, a judgment against an individual partner will not create a lien on the partnership property; the lien will attach only if the judgment is against the partnership. Other state-specific statutes relate to spousal interests in partnerships. For example, in some states, a married partner’s spouse does not have dower rights in the partnership property. When a partner dies, that interest in the partnership property passes to the surviving partners. The deceased partner’s family has no claim on it.

Other Organizations

There are other ways to organize for owning real estate or operating a business.

Limited Liability Companies (LLCs)

A limited liability company (LLC) is structured similarly to a corporation, thus the limited liability, but has tax benefits of a partnership (e.g., no double taxation of profits). Owners of an LLC, who are called “members,” are protected to some degree because, as with a corporation, they have limited personal liability for the actions and debts of the LLC.
LLCs have the added benefit of allowing pass-through income taxation, much like a partnership or subchapter S corporation. Creating an LLC is generally considered to be less involved than incorporating; however, like corporations, the laws of each state dictate the creation and function of LLCs.

**Trust**

A **trust** allows the owner of property, known as the **trustor**, to transfer ownership to someone else, the **trustee**, in order for them to manage the property for a third party, the **beneficiary**. A trustor may be an individual or a company. A trustor might establish a trust to reduce inheritance taxes or to direct an estate. The terms of the trust define the trustee’s powers.

When a **trust is established in the trustor's lifetime**, it is known as a **living trust** or an **intervivos trust**. A **trust established by will or after the death of the trustor** is a **testamentary trust**. Most states permit real estate to be held in trust, though the laws regarding trusts can be complex and can vary greatly from state to state.

**LAND TRUST** In a **land trust**, the only asset is real estate. The **beneficiary** actually directs control over the property and has the right to possess it and earn income from it or from the proceeds of its sale. With a land trust, the beneficiary and the **trustee** are often the same person. Generally speaking, land trusts are not recorded in the public record and, therefore, the beneficiary remains **anonymous**. An exception to this is when the property in a land trust is subdivided, at which point, the beneficiary must reveal his identity.

**Real Estate Investment Trust (REIT)**

A **real estate investment trust (REIT)** is a **real estate investment business with at least 100 investors, organized as a trust**. The Federal Real Estate Investment Trust Act of 1960 created this form of real property ownership to give tax benefits to real estate investors who organize their business as a trust. Here, one or more trustees manage property for the benefit of the beneficiaries. A trust document vests title to the property in the trustees, who have only power expressly granted to them in the trust document. The beneficiaries have no legal interest in the property; they have only the power to enforce the performance of the trust.

As previously mentioned, a REIT must have at least 100 investors, who are the beneficiaries of the trust. If a REIT distributes over 90% of its income to its investors, it pays corporate taxes only on the income it retains. So, the federal government taxes 90% (or more) of the earnings only as the investors’ personal income, not as the REIT’s income. A REIT also shields the investors from liability for the REIT’s debts, similar to the corporate shareholder structure.

**Syndicates and Joint Ventures**

- **A syndicate** (or syndication) is a **type of joint participation of individuals, partnerships, and corporations in a real estate investment**. However, the syndicate is not recognized as a legal entity as a corporation would be. A syndicate allows most property ownership forms possible (joint tenancy, tenancy in common, partnership, corporation, etc.) and is generally used for large-scale, ongoing projects or multiple projects.

- **A joint venture** is an **arrangement in which two or more individuals or companies pool resources to engage in one project or a series of projects but not as an ongoing business concern**.
Sole Proprietorship

A sole proprietorship is a business owned by a single individual (or legal spouses for tax purposes) in severality. With this structure, the owner is personally responsible for any business debts. In the event of default, a creditor can attach personal assets (except for property that is owned with a spouse as tenants by the entirety).

A sole proprietorship can operate under the sole proprietor's name or under an assumed or fictitious name, if registered with the state; for example, Joe Smith doing business as (dba) Smith Realty or Patsy Davis also known as (aka) Patsy Cakes.

The owner can terminate a sole proprietorship at any time. And, obviously, it terminates with the death of the sole proprietor.

Condominiums and Cooperatives

Condominiums and cooperatives have become familiar ownership options in many parts of the country. Home buyers may choose a condo or co-op as a way to live where single-family homes are scarce or nonexistent. Others prefer a lifestyle that offers freedom from lawn chores and home maintenance in a downsized, easy-to-manage living space. Condo and co-op living offers all of that and more, but these properties are different from traditional single-family home ownership in a variety of ways. Condominiums, cooperatives, and similar housing alternatives combine individual ownership with co-ownership in both the physical and legal realms.

Condominiums

Condominiums are properties developed for co-ownership, where each co-owner has a separate interest in an individual unit and an undivided interest in the common areas of the property. Keep in mind that a condominium is a form of ownership, not a physical description of the property. While developers may establish condominiums as office buildings and retail centers, most condominiums—or condos—are residential. Keep in mind that a condominium is a form of ownership, not a physical description of the property. A condominium could be a large multi-family highrise or a row of dwelling units separated by a common wall under one roof, for example. Condos are considered real property and owners hold a fee simple deed to the interior space of their individual condo unit. For that reason, a condominium owner’s interest in a unit is sometimes referred to as an “air lot,” particularly when referring to units in high-rise buildings. Another term used for condominium ownership is “paint-to-paint” to signify that what is owned in fee is the space inside the walls.

Common and Limited Common Areas

Each resident usually has exclusive ownership of one unit in severalty or co-ownership. The other parts of the property—the grounds, the recreational facilities, the building’s lobby, and hallways—are called the common areas. These are owned by all residents as tenants in common.
A condominium owner also has exclusive use of limited common areas, which are parts of the condominium project owned by all but used exclusively by one.

For Example

A porch outside a unit may be in the common grounds area owned by everyone but may be limited exclusively in use to the owner whose property it adjoins. Another example would be designated parking spaces. The words “designated” or “assigned” describes an amenity that is reserved for the exclusive use of one resident, even though all the owners own the land.

Condominium Development

Every state has passed laws that create the legal framework for a condominium form of ownership. Known generically as horizontal property acts or horizontal property regimes, these laws make it possible to define actual ownership rights. This, in turn, makes it possible for lenders to provide mortgages on condominiums and for tax authorities to assess property taxes, among other things.

The sponsor, or developer, is the person, corporation, or other entity that directs the sale and development of the property. Sponsors establish and record a declaration of covenants, conditions, and restrictions (CC&Rs), which create a general plan of private restrictions for a subdivision. For example, CC&Rs might stipulate that owners cannot paint their front doors certain colors, cannot install a satellite dish, can use only white holiday lights outside, or can have only a certain type of patio furniture.

The purpose of CC&Rs is to keep the community attractive and uniform and to protect its market value. For a condominium development, CC&Rs dictate the rules unit owners and their guests are required to follow. CC&Rs are binding on all unit owners and are usually enforced by a condominium association. Penalties for violating the condominium’s CC&Rs could include fines, lawsuits by the condominium association, or forced compliance.

In addition, the sponsor establishes bylaws, which are the rules and regulations that govern the actual management and maintenance of the condominium and the running of the condominium association.

Encumbrance and Transfer

Each owner may give a lender a mortgage on his unit and his accompanying undivided interest in common areas. Each owner’s creditors can claim a lien against an individual’s unit and undivided interest in the common areas. If a lienholder forecloses on a condominium, only that unit and its undivided interest are affected. A lienholder cannot foreclose on the entire condominium complex. The government levies ad valorem property taxes against each unit separately, so a tax lien foreclosure will not affect the whole property.

When a condominium unit sells, an undivided interest in common areas and membership in the owners association automatically transfers, too. An owner cannot sell his unit without transferring his interest in the common areas or sell his interest in the common areas separately from his unit.
Cooperatives

Cooperatives are buildings owned by corporations. A corporation formed for the cooperative holds title to a cooperative property in severality.

A person who wants to live in the building buys shares in the corporation, instead of renting or buying a unit, and receives a proprietary lease for a unit in the building. The proprietary lease has a longer term than most ordinary leases and gives the shareholder more rights than an ordinary tenant would have. A co-op owner’s shares are considered personal property. This differs from a condominium purchase, which is a fee simple transaction where the unit owner receives a deed to the property.

Encumbrance and Transfer

A cooperative shareholder pays a prorated share of the building’s expenses, including property taxes for the whole building. Unlike a condo, where one resident’s actions do not threaten the entire community, if a co-op resident does not pay his or her share of the building’s expenses, the entire cooperative must make up the unpaid portion. If the cooperative has a mortgage on the building, and an owner or several owners do not pay their portions, the building itself may be threatened with foreclosure.

To transfer an interest in a cooperative, a shareholder conveys his stock and assigns the proprietary lease to the new shareholder. Since the financial instability of one person can jeopardize the whole cooperative, an agreement may provide that a shareholder cannot transfer an interest in the cooperative without the other shareholders’ consent. Prospective buyers will present a board package to the co-op board of directors that includes such information as financial qualifications, employment verification, letters of reference, and other material requested by the board.

Townhouses

Townhouses, or townhomes, are properties developed for co-ownership where each co-owner has a separate fee simple interest in an individual unit, including the:

- Roof
- Basement
- Ground directly beneath the unit, also called a zero lot line
- Patio space

Each co-owner also receives an undivided interest in the common areas of the property. This differs from condominium ownership, where the fee simple interest is in the airspace only. In townhouse ownership, the fee simple interest includes the land beneath the footprint of the dwelling. Typically, townhouses have a shared wall, sometimes called a party wall, between each unit.
**Timeshares**

*Timesharing* is a form of property ownership, typically for resort properties, in which several buyers purchase an interest in the same property, generally as tenants in common. Each party pays for the right to use the property and facilities for a designated period of time, generally one week a year. As part of their timeshare agreement, the timeshare owner may also pay an annual fee that covers expenses such as maintenance, management, maid service, utilities, linens, etc.

Most states have specific statutes governing the sale of timeshares. Some states require a real estate license to market and sell this form of ownership; others do not.

Generally speaking, timeshares may be set up in two ways:

- A **right-to-use** timeshare is a leasehold interest in which a buyer pays an up-front fee to simply occupy a unit in the timeshare property for one week a year for a specified number of years.

- A **deeded** or interval timeshare is a fee simple ownership interest in which a buyer pays an upfront fee to co-own a unit in the timeshare property, as well as to occupy that unit for one week a year. A unit generally has 50 co-owners, with two weeks reserved for maintenance each year. Since this type of interest is fee simple, it includes the bundle of ownership rights, including the right to will the property to someone else.
Challenge Activity

Match the term to the definition.

A. Common Areas  G. Limited Common Areas  M. Tenancy by the Entirety
B. Condominium  H. Limited Liability Company  N. Tenancy in Common
C. Cooperative  I. Nonmarital Property  O. Timeshare
D. Corporation  J. Ownership in Severalty  P. Trust
E. General Partnership  K. Partnership  Q. Undivided Interest
F. Joint Tenancy  L. Proprietary

___ 1. A legal arrangement in which title to property is vested in one or more trustees who manage the property on behalf of the beneficiaries.
___ 2. A co-owner’s interest that provides the right to possession of the whole property.
___ 3. The land and improvements in a condominium or cooperative that all residents use and own as tenants in common.
___ 4. A business ownership structure in which profits are passed through to the owners and taxed on their personal income tax returns.
___ 5. A type of property ownership under which residents have the right to occupy a unit by purchasing stock shares.
___ 6. Association of two or more people to carry on business for a profit.
___ 7. A legal structure authorized by state law that allows a business to organize as a separate legal entity from its owners.
___ 8. A form of co-ownership with two or more persons having an undivided interest in the land but no right of survivorship.
___ 9. Each co-owner has an equal, undivided interest in the land and stated right of survivorship.
___ 10. Areas in a condominium or cooperative owned by all but used by only one owner.
___ 11. An exclusive, longer-term lease given to a person who lives in and owns stock in a cooperative.
___ 12. Any property that was owned prior to a marriage or civil union or that was given only to one spouse or partner during the term of the marriage or civil union.
___ 13. A form of property ownership in which several buyers purchase interests in real estate with each party having the right to use the property and facilities for a designated period of time.
___ 14. A partnership in which each member has an equal right to manage the business and share in the profits as well as equal responsibility for debts.
___ 15. A property developed for co-ownership where each co-owner has fee simple interest in individual units and undivided interest in common areas.
___ 16. Ownership by a single individual.
___ 17. A form of property co-ownership by legal spouses.
Summary

1. A property owner can hold ownership in **severalty** (one person or legal entity) or **co-own** a property with one or more other people, each having an undivided interest. **Undivided interest** means each co-owner has a right to possession of the whole property, not just part of it.

2. Forms of co-ownership are: **Tenancy in common**, **statutory survivorship tenancy**, **joint tenancy**, or **tenancy by the entireties**. If title is severable between co-tenants, then title is a tenancy in common.

3. Associations of individuals can hold title to real property: **Corporations**, **general and limited partnerships**, or **REITs**. Corporations own property in severalty; general partners own property as tenants in partnership.

4. The owner of a **condominium** unit owns the unit in severalty and has an undivided interest in the common areas. A corporation owns a **cooperative**, with each shareholder having a proprietary lease for one unit.
Chapter Quiz

1. L and C are married and decide to buy some investment property together. L wants to make sure that if she dies, her daughter from a previous marriage will be able to inherit her interest in the property. How should L and C take title to the property?
   A. joint tenants
   B. tenants by the entirety
   C. tenants in common
   D. tenants in severalty

2. Which of these unities is required for there to be tenancy in common?
   A. possession
   B. interest
   C. time
   D. title

3. J and friend L buy a $250,000 house together as tenants in common. J pays $200,000, and L pays $50,000. The deed indicates that J owns 80% interest, and L owns 20% interest. How much of that property can L occupy?
   A. 25%
   B. 50%
   C. 100%
   D. whatever J and L agree to

4. P and Q just got married, and P moves into the house Q owned in severalty prior to the wedding. Which of these unities is present with respect to the ownership of the house?
   A. interest
   B. time
   C. title
   D. person

5. When V and C get married, they decide to sell each of their homes and buy one house together. V’s house sells for $700,000; C’s house sells for $300,000; and they’re going to buy a $1 million house. If V wants a 70% interest in the new house, what form of ownership must they take?
   A. joint tenancy
   B. tenancy in common
   C. tenancy by the entirety
   D. tenancy in severalty

6. G and J are getting divorced and decide to sell their house. Before the house sells, however, the divorce is finalized, and the judge awards the house to J as part of the divorce settlement. When the new deed is prepared, what is J’s likely interest in the house?
   A. joint tenant
   B. tenant in common
   C. tenant by the entirety
   D. tenant in severalty

7. H, Y, K, and R co-own a property as joint tenants. When R, K, and Y are killed in a car accident, what is H’s interest in the property?
   A. H is a joint tenant with 100% interest.
   B. H owns the property in severalty.
   C. H still owns 25%, and the rest is split between the heirs of R, K, and Y.
   D. The estate ends at the death of the majority of the co-owners.
8. A and B each own a one-third interest in a property as joint tenants with right of survivorship. D owns a one-third interest in the property as a tenant in common with A and B. When B dies, what happens to his interest in the property?
   A. It is split equally, so A and D each have a 50% interest.
   B. It goes to A, who now has a two-thirds interest.
   C. It goes to B’s heirs, leaving A and D with their one-third interest.
   D. It must go to probate court for a determination.

9. K, S, and L own a house as tenants in common. When S dies, her 25% interest
   A. goes to her heirs.
   B. goes to K and L, split equally.
   C. goes to K and L in proportion to their ownership interests.
   D. It’s impossible to know.

10. Joint tenancy is severed when
    A. one of the owners files for bankruptcy.
    B. one of the owners sells his interest to a third party.
    C. one of the parties becomes disabled.
    D. the leasehold expires.

11. What is the only form of co-ownership that permits the division of property in unequal proportions?
    A. joint tenancy
    B. severalty
    C. tenancy by the entirety
    D. tenancy in common

12. ABC, Inc. just bought an old warehouse to turn into a state-of-the-art bakery. How does ABC take ownership of the property?
    A. joint tenants
    B. in severalty
    C. real estate investment trust
    D. tenants in common

13. Which type of business entity pays a share of the profits to its beneficiaries?
    A. corporation
    B. joint venture
    C. REIT
    D. syndicate

14. T makes brother B the trustee of the family farm for the benefit of her daughter D. Who actually holds title to the property?
    A. brother B
    B. daughter D
    C. mother T
    D. T, B, and D as tenants in common

15. A hundred doctors get together and put in $10 million each to purchase every strip mall in town as they become available over the next several years. This is most likely an example of a
    A. general partnership.
    B. joint venture.
    C. syndicate.
    D. trust.

16. S is the beneficiary of a parcel of land, although his interest in the property is anonymous. Before he can subdivide the land for a housing development, he must reveal his name. What type of trust does this describe?
    A. land trust
    B. living trust
    C. real estate investment trust
    D. testamentary trust

17. S has a designated parking space at his condo. This is an example of a(n)
    A. alternative leasing.
    B. common area.
    C. declaration.
    D. limited common area.
18. T has a proprietary lease on an individual unit in Royal Tower Residences. Most likely, what does T own?
   A. a condominium unit
   B. a deeded timeshare
   C. shares in a cooperative unit
   D. shares in real estate investment trust

19. W just bought a condominium. Which statement regarding W’s ownership is TRUE?
   A. The government levies property taxes against W directly.
   B. W has a proprietary lease.
   C. W may not devise the property.
   D. W must take title as a joint tenant with other owners.

20. N is a co-owner of a property in Orlando. He is permitted to stay there only the first week of December and the third week of June every year. N MOST LIKELY owns a
   A. cooperative.
   B. condominium.
   C. leasehold estate.
   D. timeshare.
Ownership of real property is transferred from one person to another in many ways. Sometimes, an owner voluntarily transfers title by deed or in a will. In other cases, title is transferred involuntarily, as in a foreclosure sale. **Alienation** is the legal term that includes all the various methods of transfer—voluntary and involuntary. This chapter describes the requirements for transfers. We’ll also look at types of deeds as well as the recording system, which plays an essential role in the transfer of real property.

After reading this chapter, you will be able to:

- Contrast methods of voluntary and involuntary alienation.
- Identify types of deeds and their requirement elements.
- Describe the value of providing notice through public records.
- Recall the purpose of title insurance.

**Key Terms**

- Abstract of Title
- Acknowledgment
- Actual Notice
- Adverse Possession
- Alienation
- Chain of Title
- Cloud on the Title
- Condemnation
- Constructive Notice
- Covenant of Quiet Enjoyment
- Deed
- Delivery and Acceptance
- Descent
- Devise
- Eminent Domain
- Equitable Title
- Escheat
- General Warranty Deed
- Grantee
- Grantor
- Habendum Clause
- Inquiry Notice
- Intestate
- Insurable Title
- Involuntary Alienation
- Limited Warranty Deed
- Marketable Title
- Quitclaim Deed
- Referee’s Deed
- Seizin
- Suit to Quiet Title
- Testate
- Title
- Title Insurance
- Warranty Deed
- Warranty Forever
Alienation

Alienation is the process of transferring title to property. Title to real property may be transferred during an owner’s lifetime by voluntary alienation and involuntary alienation.

Voluntary Alienation

Voluntary alienation is the most common way to transfer ownership of real property. Voluntary alienation is an action that the property owner takes of his or her own free will. It may be accomplished through various methods, for example:

- **Sale** of property, in which the owner agrees to hand over title in exchange for consideration; usually completed with a deed
- **Gift** of a deed; for example, a father deeds part of the family farm to his child
- **Dedication** of private property for public use; for example, a developer dedicates land for streets within a new subdivision or a property owner dedicates land to a municipality for a park
- **Grant** of title to property from the government to an individual; for example, historically, governments issued land grants to public companies to build railroads and to colleges and universities to establish campuses

Be aware that many of the topics discussed in this chapter fall within the practice of law. Any advice given to a buyer or seller could be construed as legal advice, which is off limits for real estate licensees. Clients and customers should be advised to seek legal counsel.

Involuntary Alienation

Involuntary alienation is the transfer of title in an interest in real property against the will of the owner, or without action by the owner. Some examples of involuntary alienation include foreclosure, adverse possession, and condemnation through the power of eminent domain.

Property can also be transferred as a result of an operation of law, such as when a married couple divorces and the court awards ownership of property to one person.

Foreclosure

A lien is a financial interest in property. It is security for a debt, giving the creditor or lienholder the right to commence a foreclosure action in the county where the property is located if the debt isn’t paid. Generally speaking, once a judgment of foreclosure is granted, title to the property goes to the lienholder, who can sell the property to recover the debt. Default on a mortgage loan is the most common reason for foreclosure; however, unpaid property or income taxes can result in a tax lien, and personal judgments can result in judgment liens against the property, either of which can lead to a foreclosure sale.
Adverse Possession

Possession and use of property can mature into title. Acquiring title to land by adverse possession requires open and notorious, hostile and adverse, exclusive, and continuous use of another’s land for a period of time as defined by the laws in each state. Adverse possession does not apply to government-owned land. Adverse possession, also known as title by prescription, is similar to easement by prescription, but instead of acquiring an easement or an interest in the property, the actual title is acquired.

Adverse possession is most likely to come into play over a disputed property line and rarely results in the conveyance of title to large parcels.

For Example

Homeowner J puts up a fence that encloses a small portion of his neighbor’s property. Over the years, he plants trees and bushes and enjoys the use of the property. Many years later when the neighbor’s property sells, the new owners discover that the fence is on their property. When the new owners remove the fence, J takes the neighbors to court to claim title to that specific portion of the property through adverse possession.

TACKING In some states, an adverse possessor may tack on time from a previous adverse possessor so long as there is privity between them, meaning some type of non-hostile relationship such as a contract or deed. This ability to use time from a previous adverse possessor is known as tacking and may allow a possessor of property to meet the statutory period without personally adversely possessing the land.

Eminent Domain

Eminent domain is the government’s constitutional power to take private property for public use—such as for roads, fire stations, or landfills—as long as the owner receives just compensation. The actual act of taking private property for public use through eminent domain is known as appropriation or condemnation. In some states, when the government appropriates private property, property owners may have the right to challenge the compensation offered, but they would not be able to prevent the taking of the property.

Conveying Estates After Death

At some point in your real estate career, you will likely come across property that is part of a deceased person’s estate or owned by someone under the care of a guardian. Broadly speaking, the transfer of property upon the death of the owner can happen through devise or descent.

Devises

A will is a person’s legally binding instructions for the disposal of property to named heirs. The will appoints an executor (sometimes called executrix if it’s a woman) to carry out the wishes of the deceased, which can happen only after the will maker dies, never sooner.
Devise is the *distribution of real property according to the instructions in a will*. While there are specific terms to cover different types of property in an estate, people often use “devise” as an umbrella term for all property.

- **Devise** involves the transfer of real property.
- **Bequest** involves the transfer of personal property.
- **Legacy** involves the transfer of money.

When someone dies with a valid will in place, he is said to have died **testate**. In order for a will to be valid, it must meet strict minimum standards. If the will does not meet those standards or if someone challenges it, a court can distribute the estate as though no will existed.

**Probate** is the process that determines both the validity of a will and the distribution of property. The term also describes the court of jurisdiction over estates.

**Descent**

When a person dies **without a will** (intestate), property automatically descends to any natural heirs or next of kin as provided for by state law through the process of **descent**. Each state has some sort of law of descent and distribution that lists those persons in a close enough degree of kinship to be considered natural heirs, for example, spouses, children, and other relatives. A court-appointed **administrator** will handle the affairs of the estate. (Sometimes, a female administrator is referred to as an **administratrix**.) This process may also be called **intestate succession**.

If a property owner dies **intestate** and there are no heirs or creditors, the property would revert to the state or possibly to the county in which it’s located, depending on the state law, through the process of **escheat**.

**Deeds**

The methods of conveying real property just discussed result in the transfer of **title** from one property owner to another. Title is NOT a document; rather, **title** to real property refers to **an actual, lawful ownership interest in that property**. Having title to the land means the person actually owns it, while a **deed** is **an instrument used by an owner of property to convey the grantor’s interest, if any, in the real property**. It is the most common way to convey title, serving as evidence of title.

This distinction is important because, although rare, it is possible to possess a deed to property, yet not have title to that property. Suppose the **seller** (known as the **grantor**) does not own the land. The grantor may think he owns a piece of land as part of a larger tract, for example. Can this grantor pass good title by merely giving the **buyer** (the **grantee**) a deed to the land? Of course not.

**Equitable title** is an interest in property created on the execution of a valid sales contract, whereby a deed transfers actual title at a future date, such as at the closing. Having equitable title is not the same as having title, but the person who holds equitable title still enjoys certain rights and privileges.
Requirements for a Valid Deed

For a deed to be properly executed, i.e., valid, in most states, it must be in writing and contain the necessary information, such as:

1. **Competent grantor’s signature** (many states require two witnesses)
2. **Identifiable grantee** to whom title will pass, named in such a way so as to reasonably separate this person from all others
3. **Words of conveyance** stating the grantor’s intent to convey the land
4. **Description** of the property being conveyed, adequate enough to distinguish it from all other parcels of land
5. **Consideration** recited to prove that a sale of land took place
6. **Acknowledgment** of the grantor before a notary public, stating that the sale of land is a free and voluntary act
7. **Delivery and acceptance** of the deed during the grantor’s life

A recital, also called a source clause, identifies the details of how and when the grantor(s) took title to the property. For example: “Being the same premises conveyed to the grantors herein by deed of ACME Construction granted June 6, 1979…” A recital is traditionally included in a deed, though not required to make the deed valid.

Competent Grantor

A **competent grantor** is a person wishing to grant or convey land, who is of sound mind for the purposes of entering into a contract, and who has reached the age of majority. A competent grantor’s signature (and the grantor’s spouse, if married, or anyone else who has a legal ownership interest in the property and the authority to carry out the transaction) is vital for a valid deed to transfer title.

The grantor’s name should be the same as the name on the previous deed as the grantee. If the name has changed, that should be noted (for example, “formerly known as…”).

**DONATIVE INTENT** Donative intent is intent by the grantor to transfer title immediately and unconditionally. This is also vital for a valid deed. Even when the grantee receives a deed while the grantor is alive, it is not effective unless the grantor intends to surrender control over the property and transfer title immediately. If the grantor retains any power to recall the deed or intends for it to take effect only under certain conditions or at some other time in the future, the deed does not transfer title to the grantee.

Identifiable Grantee

An **identifiable grantee** is a person to whom the interest in real property is to be conveyed, identified in such a way so as to reasonably separate this person from all others in the world. This would include the proper and complete legal names of the grantee(s), as well as any generational designations (e.g., Jr., Sr.). The names sometimes include the marital status (for example, “husband and wife,” “single man (never married),” “widow/widower,” “unmarried woman (formerly married),” etc. The grantee is not required to sign the deed.
Words of Conveyance

Words of conveyance constitute a clause in the deed that states the grantor intends to convey title to the land. Also called the granting clause, these words identify the document as one that involves the transfer of interest from one person to another. The wording of the deed must be such that it communicates a definite and clear intent by the grantor to part with the subject land. The words “give,” “grant,” “bargain,” “sell,” and “convey” leave no doubt as to the intent of the grantor.

The habendum clause, included after the granting clause in many deeds, begins “to have and to hold” and describes the legal rights being conveyed, for example, a fee simple estate or a life estate.

Description

The description of the property being conveyed should be thorough and complete. The test of a property’s valid description is the ability to identify and distinguish that property from any and all other parcels of land in the whole world. Legal descriptions are based on one of the following methods (which are covered in detail in a later chapter):

- The rectangular survey method is a legal description for land referencing principal meridians and baselines designated throughout the country. This is also known as the government survey system.
- The metes and bounds method is a legal description that starts at an easily identifiable point of beginning, then describes the property’s boundaries in terms of compass directions and distances, ultimately returning to the point of beginning (POB).
- The lot and block method is a legal description used for platted property. The description states only the property’s lot number and block number in a particular subdivision. To find the exact location of the property’s boundaries, the interested party must consult the plat map for that subdivision.

Consideration

Consideration is anything of value (e.g., money, goods, services, promises) given to induce another person to enter into a contract. Consideration recited on the deed is necessary to prove that a sale of land took place and that the transfer was not a gift since creditors might challenge a gift as a fraudulent transfer of assets. In some states, the deed does not need to recite the actual price paid, except in cases involving public sale (e.g., at foreclosure), in which case the full consideration is required. Other states require the full consideration to be stated and acknowledged by the grantee.

If someone is truly giving the property as a gift, then the deed may state the consideration as “For the love and affection given to me by my daughter, I hereby deed to her the following real property.” This would be called good consideration.

When a grantor gifts title of real property to someone outside of the family, heirs or other family members may be able to challenge the validity of the deed.
Acknowledgment

Acknowledgment occurs when a party signs a document before a notary public, stating she signed it voluntarily. In the case of a deed, the grantor acknowledges before the notary public that the act of selling the land is an act of free will. After a formal declaration before the authorized official (the notary), the official then certifies the signature is voluntary and genuine.

An acknowledgment is NOT a required element of a valid deed in many states, though it would most likely be required in order to record the deed.

Delivery and Acceptance

Even when a deed has been properly executed, it has no legal effect until:

- **Delivery** by the grantor. The grantor actually places the document in the grantee’s possession or gives it to a third party with instructions to turn it over to the grantee.

- **Acceptance** by a grantee. The law presumes the deed has been accepted as long as the grant is beneficial to the grantee.

Once a deed has been effectively delivered, the grantee holds title to the property and cannot reconvey the deed simply by destroying the deed or returning it to the grantor. The grantee would have to execute a new deed transferring title back to the original grantor. A deed must also be delivered to the grantee while the grantor is alive, or it has no legal effect.

Types of Deeds

There are several basic types of deeds. All deeds convey title equally well. The differences among these various types of deeds are only in the promises, if any, that the grantor is willing to make to the grantee. Such promises in a deed are known as covenants or warranties.

Warranty Deeds

Warranty deeds carry the promise of clear title and the grantor’s right to convey title. They transfer title in real property, with the grantor making certain guarantees to the grantee regarding the status of the title. For example, if the grantor is married and fails to obtain a required dower release from his spouse, that is a breach of warranty under a warranty deed. The guarantees that go with a deed differ depending on whether a general warranty deed or a limited warranty deed is used.

General Warranty Deed

General warranty deeds are deeds in which a grantor warrants title against all defects that may have arisen before or during the grantor’s ownership. These are also called standard warranty deeds or, sometimes, simply warranty deeds. A general warranty deed gives the grantee the greatest possible protection. Grantor guarantees typically include the following covenants:

- **Covenant of Seizin.** The grantor owns the estate and has the right to convey it. Also spelled seizin and seisin.

- **Covenant Against Encumbrances.** The property is free of liens or easements that are not already recited as exceptions in the deed.
• **Covenant of Quiet Enjoyment.** The grantee can possess the land without claims of title from others.

• **Covenant of Warranty Forever.** The grantor will defend the grantee’s interest against all lawful claims of title.

General warranty deeds are commonly used for property transfers. A general warranty deed may include a statement such as: “I convey and warrant...”

**Limited Warranty Deed**

Limited warranty deeds are deeds in which the grantor warrants the title only against defects arising **during the time that he owned the property**, and **not against defects arising before that time**. They are also called **special warranty deeds**. This type of deed is not so broad. With a limited warranty deed, the grantor:

- Guarantees he did not create any encumbrances.
- Promises to defend title against anyone making a claim under his ownership.

**Deeds Without Warranties**

Deeds without warranties can also transfer title to real property, but the grantor makes no warranties regarding title, nor does the grantor guarantee that he even has the right to convey title.

**Quitclaim Deeds**

Quitclaim deeds convey any interest in real property the grantor has at the time the deed is executed. A quitclaim deed makes no warranties whatsoever regarding the title held by the grantor. It conveys whatever right, title, or interest the grantor holds in the property without representation that there is any interest at all. Often, quitclaims are used to clear up problems with the title, known as **clouds on the title**. For example, a common use of a quitclaim deed is to correct an error or to acknowledge a name change. A quitclaim deed may also be used to convey an easement.

A correction deed, also called a deed of confirmation, could also be used to correct an error in a previous deed, such as misspelled name or an error in the property description.

**Bargain and Sale Deeds**

Bargain and sale deeds imply the grantor owns the property and has a right to convey it, but there are no warranties that go with it. These are sometimes used for foreclosure and tax sales.

**Fiduciary Deeds**

Fiduciary deeds are executed by a trustee, executor, or other fiduciary, conveying property that the fiduciary does not own but is authorized to manage. A fiduciary is a person appointed to act on another’s behalf. The fiduciary cannot give general warranty provisions since the fiduciary is merely acting on behalf of someone else. The only warranties fiduciaries can give, by law, involve their role as fiduciaries, not the state of the title to land. Fiduciaries warrant that they have been duly appointed by a court of competent jurisdiction as fiduciaries and that the act of selling the subject land falls within the duties, as outlined, in their fiduciary relationships.
The name of the deed being used reflects the role of the person executing the deed:

- **Executor's Deed.** Used to convey property of the deceased.
- **Administrator's Deed.** Used by someone appointed by the court to convey property of the deceased.
- **Guardian's Deed.** Used to convey property by a court-appointed representative, such as for a minor or mentally incompetent person.
- **Sheriff's Deed.** Used in sheriff's sale at foreclosure. May be called a Master Commissioner Deed.
- **Referee's Deed.** Used in bankruptcy or foreclosure proceedings.

![Image of a Warranty Deed]

**Figure 6.1 Sample Warranty Deed.**

1. Grantor
2. Consideration
3. Words of Conveyance
4. Grantee
5. Recording Stamp
6. Description
7. Habendum Clause
8. Acknowledgment
9. Transfer Tax Stamp
**Recording a Deed**

Usually, the final step after delivery and acceptance of a deed is filing the document in the county clerk’s office where the property is located. **Recording** a deed makes its existence clear to third parties as part of the public record and ensures against lost documents. In addition to the elements required to create a valid deed, these elements generally need to be present in order to record the deed:

- A public official, such as a notary public, must serve as a legal witness to the grantor’s **acknowledging signature**.
- A **certificate of the address of grantee** ensures that tax authorities are informed as to where to send tax bills.
- Some states require a statement that the **consideration** shown is true, as well as the **fair market value** of the property if different from the full consideration.
- In most states and some local jurisdictions, there should be evidence of **real estate transfer tax**, which is often in the form of a stamp.

Deeds are NOT required to be recorded to be valid; an unrecorded deed may, in fact, be valid, but it does not protect the grantee against challenges. Similarly, recording an invalid deed does not make it valid.

**The Public Records**

**Recording** is the act of filing a document in the county where the property is located so that it will be placed in the public record. The public records system is a way to provide **notice** so that the public is able to determine who holds an interest in any piece of property. By making it possible to determine who holds an interest in any property, the recording system protects real estate buyers and lenders against secret conveyances and encumbrances.

Any legal document that affects title to real property should be recorded, to provide adequate protection to the lienholder, including:

- Deeds
- Easements
- Restrictive covenants
- Court orders
- Long-term leases

Certain documents have no legal effect unless they are recorded (e.g., mortgages, mechanic’s liens). Other documents are binding on the parties even if they are not recorded.

**The Recorder’s Office**

To record a document, someone must file it at the county recorder’s office and pay the recording fee. Today, many counties utilize electronic systems to scan, or digitize, documents for storage as pictures or text documents. These images can be viewed and printed from computers in the recorder’s office or online.

The office will process the documents in the order they are filed. This is very important since deed priority or lien priority often depends on when the documents were filed.

Recorded documents maintained by the county recorder’s office are the **official, legal** documents. The office usually returns the original documents to the owner.
Notice
When two people have conflicting claims, sometimes their rights and liabilities depend on whether one had notice of the other’s claim.

Constructive Notice
A person is considered to have constructive notice of something when it should be known, even if it is not. Since the public records are available for anyone’s inspection, the law holds that everyone is considered to have constructive notice of the contents of recorded documents. The burden of discovery rests with the public.

Actual Notice
Furthermore, the law expects a buyer or lender to search the public record for his or her own protection. This results in actual notice, which exists when individuals have actual knowledge of a fact. Actual notice includes what someone personally saw, heard, read, or observed.

Inquiry Notice
A person is said to have inquiry notice when there is some indication of a claim or other circumstance that would lead a reasonable person to be alerted to a possible problem, and cause further inquiry into the condition of the title. If a person does not find out about the claim because he fails to investigate any further, he may still be held to have had inquiry notice of the claim. When someone is in possession of the property, a buyer is held to have inquiry notice of the possessor’s claim—even if the buyer never visited the property. This is why it is a bad idea to buy real estate sight unseen.

Marketable Title
When conveying real property, the seller is generally expected to deliver marketable title, also known as merchantable title. This is a title that is free and clear from undisclosed encumbrances or other defects that would expose a purchaser to litigation or impede a purchaser’s ability to enjoy the property or to later sell the property easily.

The chain of title is a clear and unbroken chronological record of the ownership of a specific piece of property. Tracing the chain of title simply means tracing the successive conveyances of title, starting with the current deed and going back a suitable number of years. Each owner is linked to the previous owner and the subsequent owner through deeds, forming a chain of title as disclosed in the public records.

Abstract of Title
A title search of the public records, also known as a title examination, is necessary to determine ownership and the quality of the title prior to conveyance. To perform a title search, a title abstractor will examine the public records for deeds, taxes, special assessments, liens, judgments, mortgages, and other encumbrances that have ever affected the property, even if the encumbrance has been removed or satisfied.

The resulting abstract of title is a chronological history of title to a property, listing all recorded documents that affect the title, as well as all public records searched, or not searched. An abstract of title does not ensure the validity of the title, and there is no guarantee associated with this type of title evidence, so the homeowner or lender does not have any recourse if title defects are discovered later.
Often, a **certificate of title** will accompany the abstract. Also called an **opinion of title**, this is a document prepared by an attorney stating the attorney’s opinion of the status of the title to a piece of property after reviewing the abstract of title.

### Marketable Title Act

Most states have some equivalent of a **marketable title act**, a law that is intended to improve the marketability of title and simplify the title search process by extinguishing certain old claims. These laws set a statutory number of years that a title abstractor must go back into through the chain of title in the public record in order to establish marketable title. The recorded deed that was in effect as of that statutory date is known as the **root of title**.

#### For Example

A state’s law indicates that an unbroken chain of title going back 40 years is evidence of marketable title. A title researcher in 2018 finds six recorded deeds on a particular parcel of land.

Going back 40 years to 1978, the owner was P Jones, who took title in 1969. That deed is the root of title. Current owner L Lu, therefore, is considered to have marketable record title. When an owner establishes a marketable record title, claims that arose before the root of title are extinguished. That said, however, certain exceptions—such as mineral reservations, government interests, or railroad and utility easements—may survive from as far back as the original grant or patent on the land. Therefore, a thorough title search could extend beyond the root of title.

<table>
<thead>
<tr>
<th>Conveyance Date</th>
<th>Grantor</th>
<th>Grantee</th>
</tr>
</thead>
<tbody>
<tr>
<td>7/12/1889</td>
<td>U.S. Land Office</td>
<td>S Brown</td>
</tr>
<tr>
<td>3/15/1934</td>
<td>S Brown</td>
<td>J Smith</td>
</tr>
<tr>
<td>6/21/1969</td>
<td>J Smith</td>
<td>P Jones</td>
</tr>
<tr>
<td>6/30/1987</td>
<td>P. Jones</td>
<td>M Jackson</td>
</tr>
<tr>
<td>8/31/2005</td>
<td>M Jackson</td>
<td>H Martinez</td>
</tr>
<tr>
<td>1/31/2013</td>
<td>H Martinez</td>
<td>L Lu</td>
</tr>
</tbody>
</table>

#### Cloud on the Title

*A gap or flaw in the chain of title*, such as an undisclosed ownership interest, creates uncertainty, which is referred to as a **cloud on the title**. A cloud on the title could be something simple. For example, Sue Jones buys a house; she gets married and is now Sue Smith. When she sells the house, the grantor name on the deed is Sue Smith. This creates an ambiguity in the title. Another common example is when a married couple purchases a home together; when one spouse passes away, a death certificate might be needed to clear any clouds on the title.

A **suit to quiet title**, also called a quiet title action, may be required to close any missing links and remove the cloud on the title. This is a lawsuit filed to determine and resolve problems of instruments conveying a parcel of real property. The purpose of this suit is to clear a known claim, title defect, or perceived defect. To close a gap and clear a cloud on the title, it may be necessary to issue a **quitclaim deed** or a **correction deed**.
The Torrens System

A few states have adopted the Torrens system of title registration as an alternative to the recording system. To use the Torrens system:

- A landowner registers the property with the state Torrens registrar.
- The registrar’s office performs a careful title search and survey of the property.
- The registrar issues a Torrens certificate; the original is kept in the registrar’s office and the property owner receives a duplicate certificate.
- When selling the property, the owner must surrender the duplicate certificate to the registrar.

Once the property has been registered (“Torrenized”), no deed, mortgage, lien, easement, or other encumbrance pertaining to it can be legally effective unless it is registered with the Torrens registrar. If someone has a lien against the property recorded instead of registered, the lien will have no effect. A prospective buyer or lender can determine the status of the title by consulting the Torrens register, without having to search the public record.

Despite its convenience, the Torrens system is rarely used, primarily because the initial registration process is expensive.

Title Insurance

Title insurance is an insurance policy guaranteeing that title to property is good title and insuring the policyholder against loss or damages from defects in the title. The defects could be liens or claims against title and may be recorded or unrecorded claims. Title insurance offers the most protection to the homeowner or mortgagee. Once a title insurance company has issued a title insurance policy, the property is considered to have insurable title.

Title insurance does not generally cure defects, although a title company could potentially purchase the property and fix the problem. More commonly, it simply insures against losses (up to the coverage amount specified in the policy) due to title defects other than those specifically excluded in the policy. It may require the title insurance company to go to court if necessary and defend its policyholder against any claim against the ownership of the property.

Title insurance is unusual in that it protects policyholders from issues that might have occurred in the past, while most other types of insurance provide protection against events that might occur in the future.

The American Land Title Association (ALTA) is a national association of title companies, abstractors, and attorneys. Members agree to promote uniformity, quality, and professional standards in title insurance policies. Policies issued by ALTA members follow specific guidelines.

Title Insurance Policies

A title insurance policy, generally paid for with a one-time premium, may have different insureds:

- Mortgagee’s Policies. The mortgagee (lender) may have a policy to protect its interests in the property. The mortgagee’s policy is for the loan amount outstanding at the time a claim is paid. The owner’s policies and the mortgagee’s policies typically coincide, so the title insurance issuer will not pay twice on the same claim.
• **Owner's Policies.** Owner's fee title insurance policies are issued in the name of the property owner. Coverage runs from the time of purchase for as long as the policyholder owns the property. When the property is sold, the new buyer must purchase a new policy name himself as the beneficiary to collect on a claim from a title defect.

• **Leasehold Policies.** A less common type of title insurance is the leasehold policy. Lessees typically obtain this type of insurance when they invest a substantial amount of money in a property, such as for an owned building that sits on leased land.

• **Easement Policies.** Another less common type of title insurance is the easement policy, which protects an easement owner's interests across another's property.

### Standard Title Insurance Coverage

With **standard** title insurance coverage, the title insurance policy states all known clouds or problems with the title, like liens or unpaid taxes. These, along with any other defects discovered in the public records (or by other means), are listed in the actual title insurance policy. Listed problems become exceptions to the title insurance policy coverage. In other words, the title insurance company writes the policy to exclude these known items from the coverage.

If there is a claim against the title by a lienholder that was disclosed to the new buyer in the title search results and stated in the title insurance policy, the title insurance company might not have to pay compensation for this claim. It would be the new homeowner's responsibility since he was made aware of this possible claimant. Title insurance protects the homeowner from claimants *not* stated in the insurance policy, including defects in the public records such as forged documents, improper deeds, and other mistakes.

**EXTENDED COVERAGE** Extended coverage title insurance policies, coverages, and restrictions are similar to a standard coverage policy with additional protections. The extended coverage policy, for example, covers additional defects in title that may be discovered only through the actual inspection of a survey. Extended coverage protects the property owner from unrecorded liens, provided the new property owner did not have actual notice of the liens. Lenders often require extended coverage.
Challenge Activity

Match the term to the definition.

A. Acknowledgment  
B. Adverse Possession  
C. Chain of Title  
D. Cloud on the Title  
E. Constructive  
F. General Warranty Deed  
G. Grantee  
H. Grantor  
I. Intestate  
J. Involuntary Alienation  
K. Limited Warranty Deed  
L. Marketable Title  
M. Quitclaim Deed  
N. Root of Title  
O. Seizin  
P. Testate  
Q. Voluntary Alienation

___ 1. Public records that show the transfer of title of real property from one person to the next.
___ 2. A document signer’s declaration to an authorized official that he or she is signing voluntarily.
___ 3. Grantor warrants the title against any and all defects that might have arisen before or during his period of ownership.
___ 4. Transfer of title to property during the owner’s lifetime without the owner’s consent.
___ 5. Title to real estate that is reasonably free of defects and encumbrances.
___ 6. Valid encumbrance affecting title in land, such as a judgment or lien.
___ 7. Deed or other document of transfer that was the first recorded instance.
___ 8. A person receiving a grant of real property.
___ 9. Title to property obtained through open, notorious, hostile, and uninterrupted possession.
___ 10. The possession or ownership of a freehold estate.
___ 11. The state of dying without making a will.
___ 12. Grants any interest in property that the grantor may have.
___ 13. A person who conveys his or her interest in real property.
___ 14. Title to property is transferred through sale, gift, dedication, or grant.
___ 15 The state of dying and having left a will.
___ 16. Notice given by publication in a newspaper, recording, or other method.
___ 17. Grantor warrants title only against defects arising during the time he owned the property.
The ORs and the EEs

If you're not sure who is the “ee” and who is the “or” in any given situation, you may have trouble when you take the state licensing exam. More importantly, you don’t want to confuse this in your practice. Remember that the suffix “or” at the end of a word indicates *the person who is performing an action or giving something*. The suffix “ee” at the end of a word indicates *the person who is receiving something or is receiving the action*.

<table>
<thead>
<tr>
<th>The Giver, Maker, or Doer of the Action or Thing</th>
<th>The Action or Thing</th>
<th>The Recipient of the Action or Thing</th>
</tr>
</thead>
<tbody>
<tr>
<td>LICENSOR (state real estate agency)</td>
<td>LICENSE</td>
<td>LICENSEE (broker or salesperson)</td>
</tr>
<tr>
<td>OFFEROR (one who makes an offer)</td>
<td>OFFER</td>
<td>OFFEREE (party to whom an offer is made)</td>
</tr>
<tr>
<td>OPTIONOR (owner, prospective grantor)</td>
<td>OPTION</td>
<td>OPTIONEE (prospective grantee, vendee or lessee)</td>
</tr>
<tr>
<td>VENDOR (seller)</td>
<td>PROPERTY SALE</td>
<td>VENDEE (buyer)</td>
</tr>
<tr>
<td>LESSOR (landlord/owner)</td>
<td>PROPERTY RENTAL</td>
<td>LESSEE (tenant/renter)</td>
</tr>
<tr>
<td>ASSIGNOR (party making an assignment)</td>
<td>ASSIGNMENT</td>
<td>ASSIGNEE (receiver of an assignment)</td>
</tr>
<tr>
<td>GRANTOR (owner/seller who is transferring title)</td>
<td>DEED</td>
<td>GRANTEE (buyer/purchaser who is receiving title)</td>
</tr>
<tr>
<td>MORTGAGOR (borrower/pledging property)</td>
<td>MORTGAGE</td>
<td>MORTGAGEE (lender/one receiving the pledge)</td>
</tr>
<tr>
<td>TRUSTOR (borrower creating a trust)</td>
<td>DEED OF TRUST</td>
<td>TRUSTEE (holds title in trust for beneficiary)</td>
</tr>
<tr>
<td>TESTATOR (maker of a will)</td>
<td>WILL</td>
<td>DEVISEE (receiver of real property interest by will)</td>
</tr>
<tr>
<td>BEQUESTOR (maker of a will)</td>
<td>BEQUEST-WILL</td>
<td>BEQUESTEE (receiver of personal property by will)</td>
</tr>
<tr>
<td>LEGATOR-TESTATOR (maker of a will)</td>
<td>LEGACY-WILL</td>
<td>LEGATEE (receiver of personal property by will)</td>
</tr>
<tr>
<td>INSURER (insurance company)</td>
<td>INSURANCE</td>
<td>INSUREE (party being insured)</td>
</tr>
<tr>
<td>CONDEMNOR (public agency)</td>
<td>CONDEMNATION</td>
<td>CONDEMNTEE (property owner)</td>
</tr>
<tr>
<td>LIENOR (claimant or creditor)</td>
<td>LIEN</td>
<td>LIENEE (debtor)</td>
</tr>
</tbody>
</table>
Summary

1. **Probate** is both the court of jurisdiction over estates and the process of proving the validity of a will. A person who dies leaving a will is said to have died **testate**. A **will** is a person's legally binding instructions regarding how his estate should be disposed of after death. A person who dies without leaving a will is said to have died **intestate**. **Intestate succession** is when property passes to a person's legal heirs because he died without a valid will. Property passes to the heirs, according to the **statute of descent and distribution**. If a person dies intestate without leaving a valid will and with no living heirs, title to that person's property **escheats** to the state.

2. The **deed** is the most important document in a typical real estate transaction—it is an instrument that conveys ownership in real property. The deed is mere evidence of title. **Title** is the actual lawful ownership of real property. Title refers to holding the rights conveyed in a transfer. For a deed to be valid in most states, it must be in writing and contain these elements: Competent grantor's signature-, identifiable grantee, words of conveyance, description of property, consideration, acknowledgment, delivery, and acceptance.

3. **Warranty deeds** include general warranty deeds and limited warranty deeds. Deeds without warranties include quitclaim deeds, bargain and sale deeds, and fiduciary deeds. **General warranty deeds** have guarantees obligating the grantor to defend the grantee from claims against the title. General warranty deeds give the grantee the best possible protection. The most common deeds without warranty are **quitclaim deeds**, where the grantor conveys only the interest he may have in the property, without warranty that he has an interest. Quitclaim deeds are mostly used to clear up **clouds on title** (e.g., a spouse releasing dower).

4. Deeds and other documents are recorded to give notice of ownership or other claimed rights. One has **actual notice** if he knows a fact to be true. One has **constructive notice** of all filings in public records. Real estate buyers have a duty to check public records for filings about the subject property. Possession or use of land by another puts buyer on **inquiry notice**.

5. A **marketable title act** says that the chain of title deeds transferring ownership need only be traced back a statutory number of years. An unbroken chain of documents going back 40 years to the **root of title** is sufficient to establish proper title. A deed that falls outside the **chain of title** because it was not recorded is called a wild deed. **Torrens System** registration could solve chain of title problems since all things must be recorded with a Torrens registrar to be valid, but this system is rarely used due to cost.

6. **Title insurance** can be standard or extended coverage and can be an owner's policy, mortgagee's policy, leasehold policy, or easement policy. It provides **insurable title**. A **standard coverage** insurance policy lists all possible clouds or problems with title (e.g., liens, unpaid taxes) and excludes those items from coverage. Title insurance protects against claimants not listed in a policy, including defects in public records (e.g., forged documents, improper deeds, other mistakes). **Extended coverage** adds protection for defects that can be known only by survey or visual inspection and unrecorded liens unknown to the buyer.
Chapter Quiz

1. During a person’s lifetime, title to real estate may be transferred by which method?
   A. descent
   B. devise
   C. escheat
   D. involuntary alienation

2. Of these, which is NOT an example of involuntary alienation?
   A. adverse possession
   B. condemnation
   C. foreclosure
   D. signing a deed

3. J granted a deed to the local school district for 10 feet of land for a walkway easement beside his house to the elementary school. This property was transferred by
   A. adverse possession.
   B. condemnation.
   C. dedication.
   D. eminent domain.

4. When a person dies with a will, it’s considered __________. When a person dies without a will it’s called __________.
   A. descent / devise
   B. intestate / devise
   C. intestate / testate
   D. testate / intestate

5. What is the term that describes how title to land is gained by the open and notorious, hostile and adverse, exclusive and continuous use of another’s land for a designated period of time, as defined by laws of the state?
   A. adverse possession
   B. eminent domain
   C. devise
   D. intestate

6. When property escheats, the title
   A. passes to the named heirs.
   B. passes to the next of kin.
   C. reverts to the named remainderman.
   D. reverts to the state.

7. Of these types of deeds, which would MOST LIKELY be used to clear a cloud on a title, such as a misspelled name?
   A. bargain and sale deed
   B. general warranty deed
   C. quitclaim deed
   D. special warranty deed

8. Title is passed once the deed is
   A. acknowledged and recorded.
   B. delivered and accepted.
   C. granted and transferred.
   D. signed and delivered.

9. Which of these elements is NOT a requirement for a valid deed?
   A. consideration
   B. granting clause
   C. legal description
   D. recital

10. Which deed is LEAST LIKELY to have been used to transfer property purchased at a foreclosure sale?
    A. bargain and sale deed
    B. judicial deed
    C. limited warranty deed
    D. sheriff’s deed

11. At closing, who signs the new deed?
    A. the buyer only
    B. the seller only
    C. both the buyer and the seller
    D. the buyer, the seller, and a witness, usually the settlement officer

12. The covenant of __________ is a guarantee that the grantor has the right to convey the property.
    A. habendum
    B. hypothecation
    C. seizin
    D. warranty forever
13. Which deed guarantees title against all encumbrances occurring during any previous ownership, usually with the phrase “convey and warrant forever”?
   A. bargain and sale deed  
   B. general warranty deed  
   C. quitclaim deed  
   D. referee’s deed

14. Why are real estate instruments recorded in the county in which the property is located?
   A. because the law requires that such instruments be recorded  
   B. because the broker cannot get his commission until these documents are recorded  
   C. to comply with the terms of the statute of frauds  
   D. to give constructive notice of an interest in a particular parcel of real estate

15. Once a person has gone to the courthouse and reviewed all documents pertaining to the property he intends to buy, he is said to have
   A. actual notice.  
   B. constructive notice.  
   C. inquiry notice.  
   D. legitimate notice.

16. The public records would be LEAST LIKELY to reveal what about a specific parcel of land?
   A. a discharged mortgage  
   B. an easement in gross  
   C. an encroachment  
   D. a pending lawsuit

17. Which of these would be considered a break in the chain of title?
   A. an easement that was not recorded  
   B. a judgment lien that was not recorded  
   C. an undisclosed owner  
   D. an unrecorded second mortgage

18. A title examiner tries to establish the present owner of a certain property by reviewing all the previous deeds of the previous owners he can find. The title examiner is trying to establish
   A. abstract of title.  
   B. certificate of sale.  
   C. chain of title.  
   D. opinion of title.

19. A title free from defects that an owner has the right to convey is known as __________ title.
   A. equitable  
   B. inequitable  
   C. legal  
   D. marketable

20. What provides the best evidence that the grantor is passing marketable title to the grantee?
   A. chain of title  
   B. deed  
   C. title abstract  
   D. title insurance policy
Describing Real Property

There are many words people use to describe property, for example, waterfront, urban, vacant, suburban, rural, corner, resort, lakeside, high-rise, cul-de-sac, farmland, rocky, isolated. No doubt you can think of others. And while perhaps helpful, these words don’t really tell us truly critical information about a parcel of land, such as: How big is it? Where exactly is it located? What are its boundaries? These questions can be answered by knowing its legal description and its dimensions.

After reading this chapter, you will be able to:

- Contrast three methods of legal descriptions for real property.
- Perform various calculations necessary to measure property.

**Key Terms**

Acre  
Baseline  
Correction Line  
Cubic Feet  
Elevation  
Frontage  
Government Survey System  
Gross Living Area  
Legal Description  
Linear Feet  
Lot  
Lot and Block System  
Metes and Bounds System  
Monument  
Plat  
Platted Property  
Principal Meridian  
Range  
Range Line  
Rentable Square Feet  
Section  
Survey  
Township  
Township Line  
Township Tier  
Useable Square Feet
Legal Descriptions

Although street addresses are useful for finding property, they do not provide an accurate description of land boundaries for the property, nor its specific location on the earth. Therefore, we must rely on legal descriptions.

The legal description of the property must identify and distinguish that property from any and all other parcels of land. Legal descriptions identify the boundaries and location of the parcel; they do NOT describe the improvements to the land. While street names may change, which would change the property’s address, a parcel’s legal description does not change.

Finding Legal Descriptions

A legal description of a specific parcel of land is usually required on these documents:

- **Deed.** A deed is an instrument that conveys ownership of real property from the grantor to the grantee. The legal description provides an exact explanation of what the grantee is receiving from the grantor.

- **Mortgage/Promissory Note.** A mortgage is an instrument that creates a voluntary lien on real property to secure repayment of a debt. The parties to a mortgage are the mortgagor (borrower) and mortgagee (lender). The note is the documented promise to repay the debt. The mortgagee needs the legal description of the property on these documents because the property is the collateral for the loan.

- **Title Insurance.** Title insurance protects the property owner against losses resulting from undiscovered title defects and encumbrances on the property. The legal description defines exactly what is insured.

Legal descriptions may also be found in an appraisal, a lease, or a purchase agreement.

Types of Legal Descriptions

There are three basic types of legal descriptions used:

- Metes and bounds system
- Government survey system
- Lot and block system

Metes and Bounds System

The metes and bounds system is a complex legal description that is used to define the location, size, and shape of a specific parcel of land. One of the oldest methods of describing property, metes and bounds was imported to the 13 original colonies from England, and states along the eastern seaboard still use it today. It is sometimes called the “surveyor’s method.”

In this system, the metes indicate distance (think of the words “metes” and “meters” to remember “distance”) and direction. Bounds indicate the boundaries of the property. Today’s descriptions generally use feet or yards as measurements. Some legal descriptions in old deeds may express the distance as perches or rods, which are synonymous terms for a measurement equal to 16 1/2 feet.
Creating a Metes and Bounds Description

To create a metes and bounds description for a parcel of land, a surveyor generally starts at a monument, which is a permanent reference mark. In earlier days, a marker or monument might have been something natural, such as a tree, a rock, a wall, or a specific bend in a river. Now, most markers are permanent physical objects, such as rods or pins that have been driven into the ground to be used as reference points.

From there, the surveyor finds the point of beginning (POB), also known as the point of origin, of the closest corner of the property. The description continues by indicating a compass direction (by degrees) and the distance to define the boundaries of the parcel, moving clockwise around each side of the entire parcel until ultimately returning to the point of beginning, closing the perimeter of the parcel.

Beginning at a point on the northeasterly side of Franklin Street extending North 78° East 168 feet from its intersection with the northeasterly side of Orchard Lane; then from said point of beginning North 78° East 140 feet along the north side of Franklin Street to the west bank of Deer Creek; then extending 122 feet along the west bank of the creek to a point; then South 78° West 140 feet to a point; then South 12° East to the point of beginning.

Monument Description

Using man-made or natural objects to delineate property boundaries is an older form of land description. This system, primarily found in rural areas, uses trees, rocks, fences, road, etc., as monuments to indicate corners and boundary lines of the property being described. Such monuments are susceptible to deterioration and eventual destruction, removal, and change in location.

Government Survey System

The government survey system, sometimes referred to as the rectangular survey system, is a type of legal description for land originally established by the Continental Congress in the Land Ordinance of 1785 to deal with the sale and settlement of large tracts of land. The system, developed by a committee led by Thomas Jefferson, divides land into a grid using a series of meridians and baselines.
Principal meridians, which run north and south, are based off the prime meridian, the line of longitude passing through the Royal Greenwich Observatory in England that is defined to be 0 degrees. A baseline is a principal east-west line of latitude. A baseline meets its corresponding meridian at the point of origin, or initial point, for the land survey. A surveyor can identify a particular parcel of land by directions and coordinates, using these lines as reference points.

Range Lines and Township Lines

Additional north-south lines, called ranges or range lines, run parallel to principal meridians at six-mile intervals. The six-mile distance between range lines is called a range.

Additional east-west lines, called township lines, run parallel to baselines at six-mile intervals. The six-mile distance between township lines is called a township tier.

The range lines and township lines intersect to form six-mile by six-mile townships. Each township has 640 acres.

Figure 7.2 Township Identification

Each township is identified by its relation to the named meridian and baseline. For example, the shaded township is T1N R3E 3rd Principal Meridian: 1 tier north of the baseline and 3 ranges east of the 3rd principal meridian.

Correction Lines Because of the earth’s curvature, range lines gradually become closer together as they extend north, causing the northern edge of townships to narrow. To account for this, correction lines, also called check lines, are established at 24-mile intervals (or at every fourth township line) north and south of a baseline. The correction lines re-establish the six-mile width between the range lines.
**Township Sections**

The 36 square miles of a township are subdivided into 36 sections of one square mile. Each section in a township is numbered sequentially starting in the upper right, or northeast corner and ending in the bottom right, or southeast corner.

Historically, Section 16 in each township was reserved for the maintenance of public schools.

**ADJOINING TOWNSHIPS** Figure 7.4 illustrates the intersection of four different townships. Remembering that each section is one-mile by one-mile, someone in Section 31 of one township who walks one mile south will be in Section 6 of the next township to the south. Similarly, someone who walks four miles west from Section 20 will be in Section 22 of the next township to the west.
Dividing Sections

Sections are divided into halves and quarters, which themselves may be further divided into halves and quarters. Each segment is, therefore, identified according to its location within the section.

For example, a parcel may be identified as \( N \ 1/2, \ NE \ 1/4 \ of \ NW \ 1/4 \).

To find that parcel within the section, always start from the end of the description, and work backward. To find the NW 1/4, look at the upper left corner, or northwest quarter, of the section first. Then, look for the northeast quarter of that quarter, and finally, find the north half of that. When adding the section identifier to the township identifier, an example of a full legal description may read: “N 1/2, NE 1/4 of NW 1/4 of Section 22, T2N, R1W of the 3rd PM.”

Figure 7.5 N 1/2, NE 1/4 of NW 1/4 of a Section

Calculating Acreage

To calculate the acreage for a given parcel of land in the government survey system, start from the end and work backward from right to left. Since the entire section equals 640 acres, take 640 and divide by the denominators (bottom number) for each fractional part. For example:

\[ \text{N } \frac{1}{2}, \ NE \ \frac{1}{4} \ of \ NW \ \frac{1}{4} \]

The calculation is \(640 \div 4 \div 4 \div 2 = 20 \) acres

Multiple parcels may be indicated by a semicolon or the word “and.” For example:

\[ S \ \frac{1}{2} \ of \ NW \ \frac{1}{4} \ and \ NW \ \frac{1}{4} \ of \ NW \ \frac{1}{4} \]

The calculation is: \( (640 \div 4 \div 2 = 80 \text{ acres}) + (640 \div 4 \div 4 = 40 \text{ acres}) \)

80 acres + 40 acres = 120 acres
Figure 7.6 One Section of Land
Challenge Activity

For the examples below, draw the indicated parcel of the section and find the number of acres.

1. N ½, NE ¼
   _______ acres

4. ______________________
   _______ acres

2. SE ¼, SW ¼
   _______ acres

5. ______________________
   _______ acres

3. W ½, SW ¼, NE ¼
   _______ acres

6. ______________________
   _______ acres
Lot and Block Description

The lot and block system is a legal description used for platted property, which is land that has been subdivided into blocks and lots. To find the exact location of a parcel, one consults a plat map, a detailed survey map of a subdivision recorded in the county where the land is located. This plat map may also be called a plot plan or recorded plat. The plat map indicates unique numbers for each lot in each block of a particular subdivision, as well as the location of the plat plan in the public records.

A legal description for the example shown using this system might be: “Mountain View Neighborhood, Section 6 Phase 1 Lot No. 211 as shown on said plan, found in Plan Book (or liber) 748, page 207.”

Elevation

To describe property’s location above or below the earth’s surface, a surveyor must know the property’s elevation, the vertical measurement above or below a fixed reference point, most commonly sea level. A standard reference point is known as a datum, which can be a point, line, or surface from which elevations are measured. A datum established by the U.S. Geological Survey (USGS) is called a benchmark. A benchmark is typically a brass marker that is permanently embedded in a road, concrete, or rock, as on the summit of a mountain. A surveyor can start at any benchmark to find the elevation of a given parcel of land or the height of a building. Many cities and other local governments have established their own local datum for official use.

A topographic map, also called a contour map, shows the elevation of a particular section of land. Contour lines show points of equal elevation at set intervals as determined by the scale of the map. For example, the contour lines might indicate a 20-foot change in elevation. The closer the contour lines are, the steeper the slope. When the lines are far apart, the slope is more gradual. Developers generally submit topographical maps as part of a subdivision plan, especially if land needs to be recontoured for some reason. The purpose of contour or topographic maps is primarily to show environmental features such as water runoff.
Measuring Property

As a real estate professional, you will likely need to do area calculations sometimes. For instance, when figuring market values of properties in an area, you may find some properties that list the square footage of a bedroom, while others just provide dimensions. You will have to convert one or the other to make a comparison. The same is true for lot dimensions. Perhaps the description lists the dimensions of a lot, but your client wants to know the size in acres.

There are four basic ways to categorize almost all of the types of measurements you need to know:

- Area measurements
- Linear measurements
- Cubic measurements (volume)
- Surveyor’s measurements (acreage)

All measurement must be in the same units before doing the calculations! For example, you may need to determine the square feet of an area using measurements that include both inches and feet. Your first step would be to convert inches to feet by dividing the number of inches by 12.

<table>
<thead>
<tr>
<th>Unit of Measure</th>
<th>Calculations</th>
<th>Conversions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Area Measurements</strong></td>
<td>Length $\times$ Width = Area</td>
<td>1,296 square inches = 9 square feet = 1 square yard</td>
</tr>
<tr>
<td></td>
<td>Area ÷ Width = Length</td>
<td>• To convert square feet to square yards, divide square feet by 9.</td>
</tr>
<tr>
<td></td>
<td>Area ÷ Length = Width</td>
<td>• To convert square yards to square feet, multiply square yards by 9.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To convert square inches to square feet, divide square inches by 144.</td>
</tr>
<tr>
<td><strong>Linear Measurements</strong></td>
<td>Length + Width = Linear Unit</td>
<td>12 inches = 1 foot</td>
</tr>
<tr>
<td></td>
<td></td>
<td>36 inches = 3 feet = 1 yard</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5,280 feet = 1 mile</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To convert inches to feet, divide inches by 12.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To convert feet to yards, divide feet by 3.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To convert yards to feet, multiply yards by 3.</td>
</tr>
<tr>
<td><strong>Cubic Measurements</strong></td>
<td>Length $\times$ Width $\times$ Height = Volume</td>
<td>• To convert cubic feet to cubic yards, divide cubic feet by 27.</td>
</tr>
<tr>
<td>(Volume)</td>
<td></td>
<td>• To convert cubic inches to cubic feet, divide cubic inches by 1,728.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• To convert cubic yards to cubic feet, multiply cubic yards by 27.</td>
</tr>
<tr>
<td><strong>Surveyor’s</strong></td>
<td>Square Feet ÷ 43,560 = Acres</td>
<td>43,560 square feet = 1 acre</td>
</tr>
<tr>
<td>Measurements**</td>
<td></td>
<td>640 acres = 1 square mile = 1 section</td>
</tr>
<tr>
<td></td>
<td></td>
<td>36 sections = 1 township</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 township = 36 square miles</td>
</tr>
</tbody>
</table>
Area Measurement

Use area measurement to find the square footage (SF) of a parcel of land, the living area of a house, or the size of a room. To find the area, multiply width by length. For example, a lot is 65 feet wide and 105 feet long:

\[ 65 \text{ feet (width)} \times 105 \text{ feet (length)} = 6,825 \text{ square feet (SF)} \]

If given the area and length, divide the area by the length to find the width:

\[ 6,825 \text{ SF} \div 105 \text{ feet (length)} = 65 \text{ feet (width)} \]

Similarly, if given the area and width, divide the area by the width to find the length:

\[ 6,825 \text{ SF} \div 65 \text{ feet (width)} = 105 \text{ feet (length)} \]

![Figure 7.8 Area Measurement: Width x Length](image)

Area of a Triangle

To find the area of a triangle, multiply half of the base measurement times the height. (Remember, multiplying by one half is the same as dividing by 2.)

\[ 200 \text{ feet} \div 2 = 100 \text{ feet} \]

\[ 100 \text{ feet} \times 350 \text{ feet} = 35,000 \text{ square feet} \]

![Figure 7.9 Measuring the Area of a Triangle](image)

You can also multiply the base times the height of the triangle, then divide by two. Either method yields the same result.
**Area of a Trapezoid**

One method is to first average the two uneven sides, known as *side opposite averaging*. To find the average, add the two uneven sides together then divide by 2. Then multiply length times width. For example, a lot measures 80’ across the back, is 50’ long, and 110’ across the front:

\[
\begin{align*}
80’ + 110’ &= 190’ \\
190’ ÷ 2 &= 95’ \\
50’ \times 95’ &= 4,750 \text{ SF}
\end{align*}
\]

Alternatively, you could determine the size of the triangle and add it to the size of the rectangle:

\[
\begin{align*}
(30’ \times 50’) ÷ 2 &= 750 \text{ SF triangle} \\
80’ \times 50’ &= 4,000 \text{ SF rectangle} \\
750 \text{ SF} + 4,000 \text{ SF} &= 4,750 \text{ SF total}
\end{align*}
\]

Note how each method yields the same result. Use whichever method you prefer.

![Figure 7.10 Measuring the Area of a Trapezoid](image)

**Area of Odd Shapes**

To calculate the area of a specific room or a house, use the same strategies for calculating the area of rectangles, triangles, and trapezoids, as appropriate. In the most basic sense, houses tend to be a collection of many rectangles.

Therefore, you can determine the total square footage by separating the house into multiple rectangles, figuring the square footage for all rectangles, then adding them together. In this simple example, the total measurement would be 1,775 square feet (150 SF + 375 SF + 1,250 SF).

![Figure 7.11 Measuring the Area of a Multiple Rectangles](image)
Calculating Interior Space

Although not a required element of a listing agreement, the square footage of a property is generally included. Prospective buyers or tenants are usually interested in this number, as it allows them a point of comparison with other properties. If a licensee chooses to include the square footage of a property in the listing agreement, fact sheets and advertisements, or the multiple listing service, he should ensure that he’s providing accurate information, as any material misrepresentation about the property would be a violation.

There are a number of factors to consider when measuring interior space:

GROSS LIVING AREA   When measuring residential property, the American National Standards Institute (ANSI) guidelines for detached and attached single-family homes assume that the square footage is measured from the exterior finished surface of the outside wall inward and includes only heated, finished living areas above ground level (often called “above grade”). This is the gross living area, also called the livable area or GLA. Finished attics may count as GLA if they have heat and electricity, finished walls, and normal ceiling height. This means garages, finished basements, and storage areas should typically not be counted as part of the total GLA.

RENTABLE VS. USABLE SQUARE FOOTAGE   In commercial real estate leases, rent is generally calculated based on the rentable square footage, which is the total floor area of a building, including all tenant space as well as common areas such the lobby and corridors. Usable square footage, on the other hand, is the amount of actual space within the perimeter of the defined space occupied by a specific tenant.

Licensees should be prepared to disclose where they obtained the reported square footage, e.g., if they measured it themselves or obtained the information from other sources, such as a previous listing, an appraisal, county tax records, a survey, etc.

Cubic Measurement

Use cubic measurements to calculate the volume of a space, for example, to determine how much dirt is needed to fill in a swimming pool, how much foam insulation is needed in an attic, or how much air can move through a building in order to install the correct size furnace.

For example, a storage warehouse is 100’ long, 75’ wide, and 22’ tall. To calculate the volume of the building in cubic feet, multiply width by length by height (or depth):

\[ 100 \text{ feet} \times 75 \text{ feet} \times 22 \text{ feet} = 165,000 \text{ cubic feet} \]

There are 27 cubic feet in a cubic yard.

To find the volume in cubic yards, divide by 27:

\[ 165,000 \text{ cubic feet} \div 27 \text{ cubic feet per cubic yard} = 6,111 \text{ cubic yards} \]
Linear Measurement

Linear measurement determines the length of something. Most often, this will be in the form of a perimeter, which is the length around something, for example, a fence around a lot. To find the perimeter linear feet, add each side of the lot. For example, let’s practice with a 65’ x 105’ lot:

\[ 65 \text{ feet} + 105 \text{ feet} + 65 \text{ feet} + 105 \text{ feet} = 340 \text{ linear feet} \]

Figure 7.13 Linear Measurement: Finding the Perimeter

Acres

Few surveyors’ measurements are part of the common vocabulary of real estate today, although an old deed might refer to “rods” or “chains” in a metes and bounds legal description, for example. On the other hand, acreage is a surveyors’ measure with which licensees must be very familiar. Acreage is another unit of area.

There are 43,560 square feet in an acre. This is a number you simply MUST MEMORIZE.

To find the acreage of a lot, calculate the square feet of the lot, then divide SF by 43,560. For example, for a lot that is 65’ x 105’:

\[ 65’ \times 105’ = 6,825 \text{ SF} \]
\[ 6,825 \text{ SF} \div 43,560 = 0.1567 \text{ acres} \]

Conversely, to determine the number of square feet when given the acreage of a parcel of land, multiply acreage by 43,560. For example, a man dedicates a 4.2-acre parcel to the city for a park:

\[ 4.2 \text{ acres} \times 43,560 \text{ SF per acre} = 182,952 \text{ SF} \]

Front Feet

Front feet are another type of linear measurement. As opposed to square feet, front feet—also known as frontage—is the portion of the lot that faces a feature such as a street, water, or rail line. In an area measurement, you may recall, frontage is always the first number indicated. So a 65’ x 105’ lot, for example, has 65 front feet.
Purchasing Land

Land is usually valued or offered for sale as a dollar amount, such as:

- Per square foot
- Per acre
- Per front feet

The frontage of land might be more valuable than its area or acreage. This is especially true for commercial property and waterfront property, where adding more frontage makes land more valuable than adding more depth. In some instances, such as for expensive waterfront property, instead of valuing property in dollars per front foot, value is measured in in dollars per front inch.

Below are some examples of how land might be sold:

<table>
<thead>
<tr>
<th>Lot</th>
<th>Size</th>
<th>Sold At</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lot in a residential subdivision</td>
<td>92’ x 127’</td>
<td>$3.80 / square foot</td>
<td>92’ x 127’ = 11,684 SF 11,684 SF x $3.80 = $44,399</td>
</tr>
<tr>
<td>Waterfront lot in that same subdivision</td>
<td>64’ x 169’</td>
<td>$92.60 / front inch</td>
<td>64’ x 12 (inches per foot) = 768 inches 768” x $92.60 = $71,117</td>
</tr>
<tr>
<td>Farmland</td>
<td>1,206,534 SF</td>
<td>$8,900 / acre</td>
<td>1,206,534 SF ÷ 43,560 SF per acre = 27.698 acres 27.698 acres x $8,900 = $246,512</td>
</tr>
<tr>
<td>Vacant lot zoned for commercial use</td>
<td>120’ x 195’</td>
<td>$4,260 / front foot</td>
<td>120’ x $4,260 = $511,200</td>
</tr>
</tbody>
</table>
Summary

1. The legal description of property identifies and distinguishes that property from any and all other parcels of land. Legal descriptions identify the boundaries and location of the parcel and usually appear in deeds, mortgages, and title insurance policies. Appraisals, leases, or purchase agreements might also include legal descriptions.

2. There are three methods to identify a site by legal description. 1. The metes and bounds system starts at a point of beginning (POB), uses compass directions and distances, may reference markers, and returns to the POB. 2. The government survey system (also called rectangular survey system) references principal meridians and baselines, divides land into 6-mile square townships. One township has 36 sections (1-mile square each); each section has 640 acres. Parcels within sections are described by directions and fractional quadrants. 3. The lot and block system describes platted property; a plat map shows lot and block numbers and is usually recorded in the public records.

3. Elevation is a property's vertical measurement above or below a fixed reference point, most commonly sea level. A topographic map shows the elevation of a particular section of land. Contour lines show points of equal elevation at set intervals. The closer the contour lines are, the steeper the slope.

4. To calculate area: $\text{Width} \times \text{Length}$. To calculate the area of a triangle: $(\text{Width} ÷ 2) \times \text{Length}$. To calculate volume: $\text{Length} \times \text{Width} \times \text{Height}$. To calculate perimeter: Add length of all sides.

5. When calculating square footage for residential property, the American National Standards Institute (ANSI) guidelines measure from the exterior finished surface of the outside wall inward, distinguishing between finished and unfinished areas of the property and between above-grade and below-grade areas to determine the gross living area or livable area.

6. Front feet, or frontage, is the dimension across the access side of a parcel of land. The access could be a road, railroad tracks, or water. When referring to lot size, frontage is the first number. Commercial land is more likely to be sold as a dollar amount per front feet, as opposed to square footage.

7. One mile = 5,280 linear feet. One acre = 43,560 square feet.
Chapter Quiz

1. Which document would LEAST LIKELY require a legal description?
   A. deed
   B. listing agreement
   C. mortgage
   D. title insurance

2. A township labeled T2S, R3W would be found
   A. 2 ranges south of a baseline and 3 tiers west of a principal meridian.
   B. 2 ranges south of a principal meridian and 3 tiers west of a baseline.
   C. 2 tiers south of a baseline and 3 ranges west of a principal meridian.
   D. 2 tiers south of a principal meridian and 3 ranges west of a baseline.

3. Which of the following describes a township tier?
   A. six-mile strip of land running east and west parallel to a baseline
   B. six-mile strip of land running north and south parallel to a baseline
   C. six-mile strip of land running east and west parallel to a meridian
   D. six-mile strip of land running north and south parallel to a meridian

4. A legal description reads as follows: “The SE 1/4 of the SE 1/4 of Section 26; and the SW 1/4 of the SW 1/4 of Section 25.” How many acres is this?
   A. 40 acres
   B. 80 acres
   C. 120 acres
   D. 240 acres

5. How many acres are there in the NE 1/4 of the NE 1/4 of Section 16?
   A. 10 acres
   B. 20 acres
   C. 40 acres
   D. 80 acres

6. A legal description reads as follows: “The NW 1/4 of Section 2; and the W 1/2 of the SW 1/4 of Section 35.” How many acres is this?
   A. 20 acres
   B. 160 acres
   C. 240 acres
   D. 320 acres

7. How many square miles are there in a township?
   A. 1
   B. 6
   C. 36
   D. 640

8. The distance between range lines is
   A. 4 miles.
   B. 6 miles.
   C. 24 miles.
   D. 36 miles.

9. Every _______ township line above a baseline is known as a correction line.
   A. 2nd
   B. 4th
   C. 6th
   D. 24th

10. If you are standing in Section 20 and go to Section 25 of the same township, what direction are you traveling?
    A. due south
    B. due east
    C. southeast
    D. southwest

11. This property description is found in a deed: “Beginning at the old oak tree, then South 15 degrees East to the embedded steel pin, thence North 90 degrees …” What type of legal description is this?
    A. government survey
    B. lot and block
    C. metes and bounds
    D. plat map
12. In the metes and bounds system the description always ends at the
A. fixed monument.
B. intersection of range lines and baselines.
C. point of beginning.
D. primary deviation.

13. To find a property described by lot and block number, look on a
A. government survey.
B. recorded deed.
C. recorded plat.
D. topographic map.

14. There’s a triangular lot that measures 1,254 feet in the front and is 820 feet deep. How many acres is this lot?
A. .42 acres
B. 11 acres
C. 11.8 acres
D. 23.6 acres

15. A square parcel of land is dedicated to the county for use as a nature preserve. The land has 1,890 front feet along the road. Approximately how many acres are there in this parcel?
A. 5.76 acres
B. 7.68 acres
C. 77 acres
D. 82 acres

16. On a plat map are two adjacent rectangular lots. Lot A has a square footage of 46,060, and Lot B has a square footage of 43,005. The common boundary they share is 235 feet long. What is the width of Lot B?
A. 183’
B. 186’
C. 189.5’
D. 196’

17. An investor is looking for a commercial property of approximately 8,000 square feet that will give her the most access to the road possible. She’s comparing four properties (frontage price indicated). She can’t spend more than $50,000. Which property is she most likely to buy?
A. 70’ x 120’ / $400
B. 80’ x 100’ / $600
C. 90’ x 90’ / $550
D. 120’ x 65’ / $460

18. A farm is being subdivided, selling at $12,500 per acre. Buyer D spends $56,250 on a parcel near the creek. What is the square footage of D’s property?
A. 196,020
B. 196,425
C. 204,120
D. 209,385

19. A 3.45-acre lot sells for 50 cents per square foot. What is the selling price?
A. $37,570
B. $75,141
C. $76,230
D. $78,712

20. An engineer needs to know the volume of a warehouse so that he can install the appropriate heating and cooling system. The building is 110 feet long, 180 feet wide, and 24 feet high. How many cubic yards is this?
A. 17,600 cubic yards
B. 39,600 cubic yards
C. 158,400 cubic yards
D. 475,200 cubic yards
The topic of agency is one of the most challenging subjects that you'll encounter as a real estate licensee, as it affects all your dealings with the public. In this chapter, we'll look at the relationship that a licensee has with a seller client and a buyer client and, more specifically, at the fiduciary duties owed to those clients. We'll see how agency relationships may be created, and how they're terminated. We'll also discuss various agency relationship options within a real estate brokerage.

After reading this chapter, you will be able to:

- Describe ways in which various agency relationships are created and terminated.
- Identify the duties that an agent owes to his or her client or customer.
- Compare various types of agency relationships.
- Discuss issues related to a licensee’s duty of disclosure.

**Key Terms**

- Accounting
- Agency
- Agent
- Attorney-In-Fact
- Brokerage
- Client
- Confidentiality
- Cooperating Agent
- Customer
- Designated Agency
- Disclosure
- Dual Agency
- Express Authority
- Facilitator
- Fiduciary
- First Substantive Contact
- General Agent
- Loyalty
- Material Fact
- Obedience
- Renunciation
- Revocation
- Self-Dealing
- Special Agent
- Stigmatized Property
- Subagent
- Traditional Agency
- Transactional Brokerage
- Universal Agent
- Vicarious Liability
What Is Agency?

Agency is a relationship of trust created when one party gives another the right to represent him in dealings with third parties. This is a consensual relationship that both enter into willingly. When buyers or sellers—or tenants or landlords—hire a real estate licensee to represent them in a real estate transaction, for example, an agency relationship may be created. The individual authorized to represent the client, therefore, is known as the agent.

The party granting the right of representation through an agency relationship, such as in a real estate transaction, is known as the client or principal in the relationship. Someone the agent works with, but not for, is considered a customer. Real estate licensees must take great care not to use the terms client and customer out of context or improperly, as it may imply a relationship not yet established.

It’s critical to note that this chapter looks at agency from a general, common law perspective. Each state has its own real estate agency laws that dictate the allowable agency relationships and the specific duties that real estate licensees owe to clients and other persons involved in a transaction. Always remember that your specific state laws supersede any of the general discussions here.

Agent Authority

The scope of authority determines the classification of an agent:

- **Universal.** A universal agent is authorized to do anything and everything that can be lawfully delegated to a representative. For example, the appointment by the court of a guardian or the granting of a power of attorney to someone (called an attorney-in-fact) can create a universal agent. Real estate licensees are rarely considered universal agents.

- **General.** A general agent is authorized to represent the principal in a broad range of matters as specified, usually as part of a long-term relationship. A property manager is an example of a general agent. Another example would be the relationship between a broker and her affiliated licensees. The broker gives general authority to her licensees to conduct real estate business.

- **Special.** A special agent has limited authority to perform a specific task or conduct a specific transaction. This is generally a short-term relationship. For example, when a client contracts with a real estate broker to sell a house, the broker is considered a special agent. A special agent may also be called a limited agent.

Actual Authority

Actual authority is power or permission that a principal intentionally gives an agent, expressly or by implication.

- **Express authority** is power or permission that the principal communicates to the agent for a specific act or outcome. As an example, express authority in an agency relationship for real estate transactions occurs when a broker and seller sign a listing agreement.
• **Incidental authority** is *the authority to do everything reasonably necessary to carry out the principal’s express orders*. This is understood to give the agent incidental authority to tell people about the house being on the market. One cannot have incidental authority without first having express authority.

• **Implied authority** results when a party’s actions, not his express words, communicate authority to act on someone’s behalf.

### Agency Creation

A **written agreement** typically establishes an agency relationship, for example, a **listing agreement** between a broker and a seller or a **buyer agency agreement** between a broker and a buyer. Some states have taken the stance that an agency agreement does not have to be in writing to be enforceable by the client, but the agent cannot enforce any commission due without a written agreement. What this means is that a broker takes on all the liabilities of an agency relationship without a guarantee of any of the benefits. There are several other ways to create an agency relationship.

### Implied Agency

The words and acts of either party can imply an agency relationship without a written contract. For example, a buyer calls a brokerage and asks if someone will show her a house it has listed. The broker shows her the house and two other properties as well. The buyer could assume from the broker’s actions that the brokerage is representing her. Implied agreements are difficult to enforce and can lead to confusion and misunderstanding between the parties, often resulting in litigation.

### Real Success

Licensees should take great care with their behavior, especially the words they speak and the statements they make. When **no relationship exists or is intended**, a real estate licensee should be **cautious** of using the following phrases to avoid implied agency:

- My seller…
- My buyer…
- I have a property…
- I have a buyer…
- I am working for you (or another unrelated party).
- I will work hard for you.
- I will do my best to see that you (get the best deal, fulfill your goals, etc.).
- I am on your side.

### Agency by Ratification

**Agency by ratification** is the *later confirmation or approval of an act that was not authorized when it was performed*. In this way, an agency relationship can arise after the fact, even without a specific agreement. If the other person later approves of these actions or accepts the benefit of the actions, she is said to have ratified them. If an agency relationship is created by ratification, the principal can be held liable for the agent’s neglect or unlawful acts just as if they had been authorized in advance.
Apparent Agency

Apparent agency occurs when someone who is not authorized to represent another, acts as if she is that person’s agent. Apparent agency can also occur when an agent acts beyond the scope of her authority, giving a third party the impression the acts are authorized. This is also called ostensible agency.

Because someone may appear to be the agent of another, even though no agency relationship has been agreed to, this can mislead third parties. There is a duty upon a would-be principal to inform these known third parties. If that doesn't happen, the principal may be held liable for the acts of the agent, just as though there had been an agreement, under the doctrine of estoppel.

Estoppel is a legal doctrine preventing a person from asserting rights or facts inconsistent with earlier actions or statements when he failed to object (or attempt to “stop”) another person's actions. Estoppel makes it legally impossible for the principal to deny the agency. By accepting the rewards of the relationship, the principal must also assume the responsibilities, even without a formal agreement. As a practical matter, however, this situation would not likely arise in the practice of real estate because of state laws on licensing and agency.

Gratuitous Agency

The payment of compensation does not create an agency relationship, nor does the absence of compensation mean that no agency relationship exists. An agent may choose to offer his services free of charge, for example, a licensee who lists his mother’s home for sale and does not accept commission for his services. A situation such as this is referred to as gratuitous agency. Although compensation is not part of the agreement, the agent is not released from his statutory obligations to his client.

An Agent’s Duties

An agent must always act in the best interests of the principal. Therefore, an agency relationship imposes certain duties, obligations, and high standards of good faith and loyalty on the agent as the representative of the principal.

In the most general sense, the relationship between an agent and a principal can be described as a fiduciary relationship, which is one of trust and confidence where one party owes the other a higher standard of good faith than she owes third parties or customers. Fiduciary duties provide a benchmark of expected performance for someone entrusted with the role of an agent. The fiduciary role is that of an advocate, and an agent owes such duties only to her client.

Common Law Fiduciary Duties

Common law is law that has developed over many years through court decisions and other precedent, as opposed to statutes adopted through the legislative process or regulations issued by the executive branch. Common law defines basic fiduciary duties that an agent owes a client in an agency relationship:
Obedience

**Obedience** means that an agent must follow the **legal directions** of the principal, obey the restrictions of the agency relationship, and not stray beyond the scope of the given authority. If agents don't follow this duty, they could be held liable to the principal for losses sustained along with other damages.

Loyalty

The duty of **loyalty** holds that the agent must put the principal's interests above all others, including the agent's own. For example, a seller client is willing to accept the first offer on her house, even though it is on the low end. The agent talks the client out of accepting the offer, knowing that it means a lower commission. In this case, the agent put his own interests above those of his client. Another example is an agent who urges a seller to accept a bad offer simply because the listing is about to expire, knowing that it's her last opportunity to earn any commission.

Disclosure

An agent must make a complete disclosure of any **material fact or defect**, which is *anything that could affect someone's decision regarding the transaction if it were known*. When considering disclosure obligations, one usually thinks about property-specific issues or facts that could affect the transaction. But the duty to disclose is much broader than that. For example, agents have a duty to disclose:

- Any relationship they may have to other parties to a transaction.
- All offers to purchase to seller clients, even if the offer seems unacceptable.
- To seller clients, a property's **true value** based on an educated analysis, as well as anything about the property or its condition that affects the value.
- Any commission-splitting arrangements with other brokers.

Confidentiality

To keep from destroying the integrity of the agency process, an agent must never share a client's confidential information or take advantage of it for personal benefit.

Without the principal's authorization, an agent cannot disclose to third parties confidential information or information that hurts the principal's bargaining position. For example, without authorization, an agent cannot disclose the fact that the seller must sell due to loss of a job, poor health, or pending divorce, or that the seller will accept less than the listing price.

Nor can an agent use confidential information learned during the course of the agency relationship later against the principal, even after the relationship ends. This includes financial information used in negotiations involving subsequently listed properties or personal information, unless the former client provides a written release.

**The duty of confidentiality remains forever, even after the agency relationship ends!**

The only instance for which an agent can, and must, relinquish confidential information is in the case of a court order. When a court demands the release of confidential information in the possession of a real estate licensee, the agent must provide it in accordance with the court's order or subpoena, but only to the party or parties named in the order.
Accounting

The duty of accounting, or accountability, recognizes that money received in an agency relationship is received on behalf of the principal, not the agent. Since an agent or broker in any real estate transaction acts on behalf of the principal, the agent has the duty to account strictly for any amounts received. For example, if a buyer provides earnest money to accompany an offer to purchase, the broker must maintain the client’s money in a separate trust account so as not to commingle the client funds with those of the brokerage. Failure to do so breaches the agency relationship, which could result in legal liability and loss of license.

Reasonable Care

Real estate licensees must use reasonable care and skill when acting on behalf of a client. Licensees should always be working in their clients’ best interest. Within that framework, the licensee is viewed as a professional and an expert. A form filled out incorrectly or a misunderstood law could cause problems for a client. If a client loses money due to a licensee’s incompetence or carelessness, the licensee can be held liable for negligence, which is an unintentional breach of a legal duty.

MINIMUM STANDARD OF COMPETENCE

All real estate licensees must adhere to a minimum standard of competence. A licensee claiming expertise in a special area (e.g., appraisal) must meet an even higher standard. Therefore, licensees should never take on tasks beyond their ability or claim expertise where they have no special training or skills. The minimum standard of competence for a real estate licensee generally includes knowledge in these areas:

- Valuing property
- Clarifying the principal’s needs
- Discovering material facts about the property, neighborhood, and parties to a contract
- Making a best effort to sell or find a property
- Explaining, in simple terms, the purpose and effect of contracts, while never practicing law without a license
- Negotiating offers and counteroffers
- Diligently meeting contract deadlines

A real estate transaction can raise many legal questions. Real estate licensees must remember—and remind their clients—if they aren’t licensed to practice law, they should never give legal advice or perform any acts that require a lawyer’s expertise. Most states, for example, allow a licensee to fill in details on standardized contracts and forms but prohibit anyone but an attorney from drafting an original agreement. To protect themselves from liability, licensees should always be prepared to advise a client to seek advice from an attorney. Similarly, if they are not qualified in an area, they must tell a client to seek advice from an accountant, appraiser, mortgage broker, or other expert.
Duties to Customers and Others

A licensee owes all the fiduciary duties to a client, but not to a customer in a real estate transaction. For example, the licensee representing a seller owes no loyalty or obedience to the buyer customer. The licensee’s duty of loyalty to his seller client prohibits this. A licensee does owe certain basic obligations to a customer, for example:

- Disclosure of known material facts about the property or transaction
- Adherence to the law
- Honesty and integrity
- Accounting for money

The Broker and Associated Licensees

Remember that a real estate licensee may not work independently of his broker and, in fact, can function only with the consent of the broker with whom he is associated. An affiliated licensee cannot independently:

- Enter into listing agreements or other contracts to represent people
- Conclude a sale
- Receive a commission
- Advertise

The licensee can only perform these actions in the name of the broker.

When a broker gives authority to an affiliated licensee to act on her behalf, the affiliated licensee becomes an agent of the broker, who is the principal in their relationship.

The affiliated licensee is the fiduciary, and all duties of good faith and loyalty to which he must adhere with respect to the broker’s clients he must also observe with his broker.

Under common law, a subagent is anyone given authority by an agent to assist in carrying out the principal’s orders. Therefore, for all intents and purposes, an affiliated licensee could be considered a subagent of the broker’s clients.

Since an agent’s authority always comes from the principal—in this case, the broker—when an affiliated licensee acts within the scope of his authority, the broker is legally liable for the licensee’s acts. This concept is known as vicarious liability. So, a third party can sue the broker instead of, or in addition to, an affiliated licensee. But if an affiliated licensee exceeds his authority, the broker may not be liable.

Real Estate Agency Relationships

With hundreds of thousands of dollars at risk and real estate lawsuits on the rise, buyers and sellers of real estate want assurance that their individual interests are protected. They want to know what type of relationship they have with a real estate licensee before disclosing confidential information regarding a real estate transaction. They want to know, “Who does my agent really work for?” And as a real estate professional, you should always be asking these questions: “Who is my client? Who do I represent?”
Single Agency
The most basic form of agency is when one agent represents just one party in a specific transaction, such as when broker A represents seller B in the sale of B’s home. This may be called single agency, principal agency, or sometimes traditional agency. This simple relationship leaves little room for confusion about who represents whom.

In the past, this traditional agency was reserved for the seller, and buyers were left to fend for themselves. Even when a buyer contacted a broker to assist with finding a home, the buyer’s interests were likely not represented. This fact may not have been clear to the buyer, who probably assumed that the broker or licensee they contacted represented them. In today’s real estate market, most brokers will take on seller clients and buyer clients.

Seller’s Agent
A listing agreement is a written agency employment contract between a seller and a real estate broker stipulating that the broker will receive a commission for finding a ready, willing, and able buyer for a seller’s property. This is the most common way to create an agency relationship between a seller and a broker in a real estate transaction.

The role of a seller’s agent is fairly clear. When representing only the seller in a transaction, the agent owes all loyalties to that seller client. The agent works to obtain the best possible terms and conditions for the seller of the property.

DUTIES OF A SELLER’S AGENT In addition to the basic fiduciary duties, a licensee representing a seller in a seller’s agency relationship should:

- Seek a purchase offer at a price and with terms acceptable to the seller. Unless the seller so directs, the licensee is generally not obligated to seek additional offers if the property is under contract.
- Accept delivery of and present all purchase offers to the seller in a timely manner, even if the property is under contract.
- Within the scope of knowledge required for licensure, answer the seller’s questions and provide information to the seller regarding any offers or counteroffers.
- Assist the seller in developing, communicating, and presenting offers or counteroffers.
- Within the scope of knowledge required for licensure, answer the seller’s questions regarding the steps the seller must take to fulfill the terms of any contract.
- Disclose material facts.

Buyer’s Agent
Most brokers today can see the advantages in providing specific representation to buyers, and buyer’s agency is quite common. When a buyer contracts with a broker to assist in the purchase of a home, the buyer is the principal.

A contract called a buyer agency agreement creates an agency relationship between a buyer and a broker in a real estate transaction. This written agency contract stipulates the broker will receive a commission when the buyer purchases real estate.
Note that in some areas, buyer’s agency is not as well established as in others. It may not be uncommon for a broker and a buyer to have only an oral agency agreement, as buyers may be reluctant to sign an agency agreement. While this might be permitted in some states, it is a dangerous practice, as the buyer’s agent has no guarantee of receiving any earned commission.

Buyer’s agents owe all fiduciary duties to the buyer in a real estate transaction. To protect against legal liability, the licensee should perform this task as diligently as he would if he himself were personally buying the property.

**DUTIES OF A BUYER’S AGENT** In representing a buyer in a buyer agency relationship, a licensee should:

- Seek a property at a price and with purchase or lease terms acceptable to the buyer.
- Within the scope of knowledge required for licensure, answer the buyer’s questions and provide information to the buyer regarding any offers or counteroffers.
- Assist the buyer in developing, communicating, and presenting offers or counteroffers.
- Present any offer to purchase or lease to the seller or the seller’s agent in a timely manner, even if the property is under contract, and accept delivery of and present any counteroffers to the buyer in a timely manner.
- Within the scope of knowledge required for licensure, answer the buyer’s questions regarding the steps the buyer must take to fulfill the terms of any contract.
- Disclose material facts.

**REPRESENTING MULTIPLE BUYERS** There may be instances where one licensee represents multiple buyers simultaneously. In most states, a licensee representing a buyer client does not breach a duty or obligation to the client by showing properties in which one client is interested to other prospective buyers (or tenants). A licensee should, however, advise all the parties of the situation, preferably in writing, as it could be considered a conflict of interest. Once the licensee discloses the information, clients can make an informed decision about whether they want to continue with the licensee or work with someone else.

**Transactional Brokerage**

If allowed by the brokerage and/or state law, licensees may work with a buyer or seller (or landlord or tenant) who rejects agency representation. In such cases, the licensee is simply assisting in the transaction in a neutral capacity without providing the fiduciary duties an agent owes to a client, such as completing the paperwork necessary to move the transaction forward. This situation may be referred to as transactional brokerage, transaction broker, non-agency, or facilitational brokerage, among other names. Transactional brokerage generally does not prevent a licensee from performing certain tasks that are administrative in nature. Depending on the state in which you practice, these so-called ministerial acts could include:

- Completing business or factual information on an offer to purchase.
- Making a referral to another broker or service provider.

Of course, without an agency agreement, a licensee cannot advise nor advocate for the consumer. Transactional brokerage obligates a licensee to nothing beyond the duties of honesty and disclosure of material facts required for customers in real estate transactions. This practice does present the danger of creating an implied agency, so licensees must be sensitive to their words and actions.
In-House Transactions

When possible, brokers like to keep transactions within the brokerage, called “in-house” transactions. This occurs when a brokerage licensee procures a buyer for one of the broker’s listed properties. While financially it benefits the broker, since it’s not necessary to split the commission with other brokerages, the situation can create risk and liability.

Dual Agency

When both the seller and buyer are clients of the same brokerage, a dual agency situation may exist. In its most basic definition, dual agency refers to one licensee who represents both a buyer and seller in the same transaction. In some states, any in-house transaction could create dual agency.

For Example

P, a licensee for ABC Brokerage, is working with buyer client M. P brings in a listing to sell L’s home. P realizes L’s house meets all of M’s requirements. If P shows L’s house to M, P becomes a dual agent. P would technically owe the same fiduciary duties to both buyer M and seller L.

J is another licensee at ABC Brokerage. J is working with buyer client H, who is interested in purchasing L’s house. Recall that the agreements the buyer and seller have with ABC Brokerage are really with the broker, not the individual licensees. The broker, therefore, could be considered a dual agent in this transaction, depending on the agency laws in that state.

LIMITATIONS ON DUAL AGENTS

While dual agency is legal in most states, a dual agent must not do anything that harms either party. A dual agent owes fiduciary duties to both buyer and seller but must remain neutral. Therefore, a dual agent cannot provide undivided loyalty to her clients, nor can she advise them on points of negotiation. A dual agent can provide facts, but not insight or counsel on how to respond to an offer or counteroffer.

A dual agent must be careful not to disclose confidential information from one party to the other party, especially regarding price or any other matter that may adversely affect one of the parties. However, a dual agent is obligated to disclose material facts and defects.

Critics of dual agency rightly point out that there is an inherent conflict of interest in the arrangement because a seller is looking for the highest price, while the buyer is looking for the lowest price. Since this type of relationship might not be acceptable to one or both parties, in most states, dual agency requires the informed written consent of both clients.

Some states do not allow a single licensee to represent both parties in a transaction.
Designated Agency

When a brokerage secures both the seller client and the buyer client in an in-house transaction, many states allow a broker to designate specific agents to advocate separately for the buyer client and the seller client in negotiating the transaction. This may be called designated agency or split agency.

A positive consequence of the designated agent function is the ability to establish—within a single brokerage—individual representation of both buyer and seller interests. Note, however, that in some states that practice designated agency, the broker may still be considered a dual agent whose loyalty cannot be divided.

Cooperative Transactions

While brokers prefer in-house transactions, they commonly extend offers to outside brokerages to sell listed property to outside buyers through the multiple listing service (MLS). The MLS exposes listings to a broader market of prospective buyers. The MLS also indicates what commission might be available to a selling agent on one of the listed properties.

When a broker submits a property listing to the MLS, the act constitutes a unilateral blanket offer of cooperation, an open invitation to other brokers to sell property listed by another broker. Outside brokers might bring buyers who are either their customers or clients, depending on how the relationship formed within their brokerage.

Subagency

As discussed earlier, a subagent is anyone given authority by an agent to assist in carrying out the principal’s orders. In most states, an offer of cooperation through a multiple listing service does not create a subagency relationship among the brokers who are members of the MLS. One reason for this goes back to the concept of vicarious liability. If an MLS listing created a true subagency relationship, then legally, the listing broker would have vicarious liability for every other member of the MLS. Even more alarming, the client could arguably be liable for the actions of any subagent.

Consequently, subagency as a business relationship between brokerages is now relatively uncommon. While subagency may not be illegal, to combat confusion, most states have passed specific statutory agency laws and regulations that clearly define acceptable agency relationships separate from common law.

Disclosure Obligations

The most basic definition of disclosure is to reveal something that was hidden. In real estate, disclosure relates to many different things. It’s critical that licensees who have superior knowledge and ability in the field of real estate not take advantage of consumers. To help address this, state laws require licensees to make certain disclosures.

Agency Relationship

A critical disclosure is the nature of the agency relationship into which a potential client is entering. This allows consumers to have full knowledge of the fiduciary duties all parties owe them. It also allows consumers to choose what sort of agency relationship is acceptable to them.
The goal of notifying the consumer of all available relationships is to allow for informed consent by the consumer as to how various parties handle confidential information. Ideally, licensees should disclose agency options as early as possible.

**Agency Disclosure Forms**

Many states require the use of a specific agency disclosure form, which defines the available relationships so that there can be no confusion as to the duties of the real estate licensee. The use of a written form provides the licensee with protection against a claim that one thing was said but another was done. This also makes the licensee accountable if the requirements are not fulfilled.

It’s important to explain to consumers that a simple acknowledgment of agency options does not create an agency relationship. In most states, such a disclosure is not a binding contract. It might be more accurately described as a consumer notice.

**Timing of Agency Disclosure**

Disclosure of agency cannot wait until an offer to purchase is prepared, but generally should be made before any confidential information can be shared, sometimes referred to as the first substantive contact.

- With a **seller**, this should be prior to presenting a comparative market analysis or entering into a listing agreement.
- With a **buyer**, this should be no later than the occurrence of certain events, such as showing a buyer property, other than at an open house, or submitting an offer to buy or lease real property on behalf of the buyer.

Note that most states have laws or regulations that mandate the specific timing for agency disclosure.

**Consumer Options**

Once the consumer reviews the options for agency representation, she may choose to:

- Enter into a **brokerage agreement**—for example, a listing agreement or a buyer agency agreement, as appropriate—and become a client of the broker.
- Refuse representation and agree to work with the broker as a **customer**, acknowledging that the licensee will provide only administrative support and that any information shared with the licensee is not confidential.

**Interest**

A licensee should disclose in writing any interest he may have in the property. Additionally, when selling or leasing real estate that they own, licensees should disclose their licensee status prior to entering into an agreement of sale or lease. It is not automatically improper for an agent to buy property from the principal, but the agent must inform the seller that the agent is the buyer. The agent must also inform the seller if the buyer is the agent’s relative or close friend, or a business entity in which the agent has an interest. This alerts the seller to a possible conflict of interest, so that the seller may choose to find another agent.

Many states require this disclosure to be included in the purchase agreement.
Self-Dealing and Secret Profits

A **secret profit** is a financial benefit that an agent takes from a transaction without authorization from the principal and without informing the principal of the benefit retained. The most common examples involve self-dealing, *when an agent buys the principal's property (or sells it to a relative, friend, etc.) without disclosing that fact to the principal, and then sells it again for a profit.*

For example, an agent has a duty to advise a seller of any steps she can take to increase the selling price of the property, such as repairs, clean-up work, or minor modifications. If the agent neglects to inform the seller, buys the property at a low price, then carries out these improvements to sell at a high price, the agent has used a superior knowledge of real estate for personal profit instead of for the principal. That is a breach of the duties of loyalty and good faith.

Material Facts

Property defects are generally categorized as either **patent** or **latent**.

- **Patent defects** are those that are *plainly observable or ascertainable*. A simple example might be a large crack in a basement wall that is easily observable upon entering the basement.

- **Latent defects** are defects that are *not plainly observable or that would not be discovered in a reasonable inspection*. If that crack in the basement wall were covered by paneling, for example, and therefore not observable, it would be considered latent. As a general rule, the seller and the seller's agent have a duty to **disclose known latent defects** to buyers.

Regardless of whether a defect is patent or latent, most states require real estate licensees to disclose **any known material facts** related to a property's condition or location. For example:

- Land or soil conditions
- The accuracy of the property's lot size or home size
- Any easements or encroachments that affect the use of the property
- Past or current pest infestation or damage
- Toxic mold, radon, asbestos, lead pipes or paint, or other interior environmental hazards
- Structural issues, such as roof, gutters and downspouts, doors, windows, chimneys, foundation
- Condition of electrical and plumbing systems
- Condition of equipment and appliances that are fixtures, such as furnaces and air conditioners
- Condition of septic systems
- Known alterations or additions
While material facts generally refer to the condition of the property, a material fact can also be considered anything that can affect the individual’s actions if it were known, for example.

- Local zoning and planning
- Boundaries of school districts
- Location within a floodplain
- Utility providers
- Airplane flight paths
- Local taxes and special assessments
- External environmental hazards such as factories, mines, or other industries

**Red Flags**

Some states have laws that require real estate licensees to make reasonable efforts to ascertain all material facts. If a licensee learns something through his efforts, the licensee must discuss this information with the client. This means that when licensees list or show property, in addition to obvious problems such as stains or cracks, they should be on the lookout for red flags that could point to potential problems. For example, here are some red flags that can indicate past flooding or water damage:

- Rotted trim wood at the base of the siding that appears to have scoring marks and powder residue
- Peeling, chipped, and cracking paint in every room
- A musty, mildew odor emanating from the basement

**Stigmatized Property**

A stigmatized property is property that may be considered undesirable because of a past event, such as a crime or death, that occurred on the site. Such issues can challenge real estate professionals. Even though they are unrelated to the condition of the property they can affect the sale of real property. For example, if the home for sale was the site of a homicide nine months ago, does the seller need to disclose it? What if many neighbors believe the house is haunted? While a seller might argue that these are not issues that affect the value or usability of the home, a buyer might argue that they are indeed material facts.

In most states, a seller is not obligated to disclose certain information, such as a murder, suicide, or accidental or natural death that took place in the home. This is generally considered to be confidential information for the sellers and immaterial to the condition of the property. Buyers may inquire about the history of the house, but the seller may not be obligated to respond. Although considered immaterial legally, however, licensees should be sensitive to how their buyer clients and customers may respond to this information.

Some states have laws that protect real estate licensees from any obligation to disclose known stigmas about the property, although they may disclose such information with written permission from the seller. Make sure you are familiar with the disclosure obligations in the jurisdictions in which you practice.
Megan’s Law

The federal government adopted Megan’s Law in 1996, requiring states to develop a procedure to notify community residents of sexual offenders living in the area. The law is intended to help parents better protect their children by providing information about potentially dangerous predators. Since sexual offenders tend to have a high rate of repeat offenses, reporting their whereabouts is considered an act of public safety.

Several lawsuits against real estate licensees have resulted since the implementation of Megan’s Law. One notable case is Glazer v. LoPreste, a New York State case in which homebuyers sued the sellers and the real estate agents for not disclosing the presence of a convicted child molester in the neighborhood. The court ruled that requiring full disclosure created an unfair duty to impose on sellers and licensees. Since the information is public and available to everyone, the court upheld the concept of caveat emptor, or “buyer beware,” and therefore, the responsibility falls on buyers to research the information. A real estate licensee is, therefore, not obligated to disclose information regarding sex offenders in the vicinity. Once sellers have actual knowledge, however, they are required to answer truthfully if a prospective buyer specifically inquires about it.

If you have a buyer client or customer who asks about sex offenders in the neighborhood, you should be cautious and direct them to local law enforcement.

Seller Property Disclosure Obligations

Many states require sellers to complete a standardized property condition questionnaire to disclose specific defects or material facts about the property. Generally, sellers must make the disclosure themselves, in whatever form the state mandates, based on their own knowledge. If sellers have no knowledge of a defect or have reason to believe it was corrected, they are not held liable for the omission.

A prospective buyer usually receives the disclosure prior to signing a purchase agreement. The disclosure allows the buyer to consider material facts prior to entering into a binding contract or to renounce the purchase agreement within some timeframe if they find an item in the disclosure to be unacceptable. Additionally, if part of the disclosure is fraudulent, there are likely other remedies available to the buyer.

In most cases, the licensee’s obligation is simply to inform the seller of her obligation to complete the form and, perhaps, deliver it to a prospective buyer or buyer’s agent. A licensee should not complete the form for the seller nor assist the seller in completing it.

Home Inspection

The use of seller property disclosure forms does not absolve the buyer of all responsibility. A buyer should always inspect the property before agreeing to buy it. As a matter of fact, an important contingency in any purchase agreement is the home inspection, which is a visual examination of the physical structure and systems of a property, usually by a licensed professional. The home inspector evaluates the quality and condition of the property. A good home inspector should have knowledge of the building process, building codes, parts of a home, and systems of a home. A home inspection will cover many areas of the home, such as the roof, mechanics, and the foundation.
There is a difference between a residential inspection and a commercial inspection in that a home inspector is not necessarily looking for code compliance, where a commercial structural inspector would. Code deficiencies will be pointed out, but this is not the primary focus of a home inspection since older homes do not necessarily have to be brought up to code.

The home inspection is geared toward finding items that are dangerous, items that are damaged, and items that don’t work. The purpose of an inspection is not to find every possible imperfection in the home—even new homes have imperfections. By concentrating on potential problems, the home inspection is trying to help a buyer make intelligent choices. Structures cannot “fail” an inspection.

A buyer’s agent plays a key role in this process by keeping track of required inspections and ensuring that all inspections are performed within the timeframe specified in the purchase agreement.

Home Warranty

Neither a home inspection nor a property disclosure should be considered a warranty, as neither provide any type of guarantee on the items or systems inspected. A homeowner can obtain a home warranty, however, that provides some degree of protection from the cost of failure to major systems and appliances. Warranties may be purchased by a homeowner at any time but are often offered by a seller to a prospective buyer as part of the purchase, which could be a factor in a buyer’s decision. A warranty does not relieve a seller of liability for failing to disclose any material defects in the property.

Home warranties, typically paid as an annual premium, may provide for discounted repairs or replacement to:

- Major systems, such as heating and cooling, plumbing, and electrical.
- Structural elements, such as roofs.
- Major appliances, such as refrigerators, dishwashers, ovens, washers, and dryers.

Some states require home builders and general contractors to provide warranties on their work, for example two years on workmanship, materials, or mechanical systems, up to 10 years for major structural repairs, such as fixing serious cracks in the foundation.

Agency Termination

An agent’s powers end when the agency relationship ends. There are several ways to terminate the relationship between a principal and an agent.

Accomplishment of Purpose

Perhaps the most common reason for termination of an agency relationship is that the purpose of the agency has been accomplished. For example, the agency relationship between a seller and a real estate broker ends when the reason for the agency relationship ends, in other words, a buyer purchases the property, and the sale closes.

Expiration

If an agency agreement specifies that the agency is for a limited term, either a certain period of time or with a set expiration date, the agency relationship ends automatically when the term expires.
Many states require that real estate agency agreements have an expiration date to ensure that the agency relationship concludes, either through accomplishment of purpose or expiration.

**Operation of Law**
An agency relationship ends automatically, as a matter of law, if certain events occur:
- The broker or the client dies or becomes incapacitated.
- The broker or the client goes bankrupt.
- The property that is the subject of the agency is destroyed or condemned.
- The broker loses his or her license.

If an affiliated licensee dies, loses his license, or declares bankruptcy, the agency relationship with the broker remains intact.

**Mutual Agreement**
An agency is a consensual relationship, meaning it is based on the consent of both parties. If both the principal and the agent desire to end the agency, they can agree to terminate it at any point. When an agency terminates by mutual consent, neither party is liable to the other for breach of contract. This is considered the best way to terminate an agency (outside of accomplishment of purpose) since it is mutually voluntary.

**Renunciation**
Renunciation occurs when someone who has been granted something or has accepted something later gives it up or rejects it. For example, a real estate broker who neglects or abandons a client with whom he has a listing agreement could be said to have renounced the agreement. With an open-ended agreement that has no specific termination date, a party may renounce the contract at any time with no further obligation. But if there is a termination date, such as with a typical real estate listing agreement, the renunciation may be a breach of contract, making one party liable to the other party for damages.

**Revocation**
Revocation occurs when someone who granted or offered something withdraws it. A principal may revoke the grant of agency powers at any time. In the case of an agreement that was open-ended, the principal may have to reimburse the agent for expenses already incurred. If the agreement had a specific termination date, however, the principal may have to pay the agent damages for breach of contract.

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**For Example**
C is planning to sell his house. He signs a 90-day exclusive listing agreement with A, a real estate broker. Two weeks later, C starts dating a real estate licensee and decides to move the listing to her brokerage. C tells A that he is revoking the agency because he is switching to a different broker.

Once C revokes the agency, A is no longer authorized to represent him, and C cannot be held liable for A’s acts. But the revocation is a breach of contract, so C may have to pay A damages, which could mean paying A the full commission she would have earned.
Agency Coupled with an Interest

There is an exception to the rule allowing a principal to revoke an agency agreement. A principal does not have the right to revoke an agency agreement if it is an **agency coupled with an interest**. This occurs when the agent holds an ownership interest in the property being sold.

**For Example**

A real estate broker and a developer become business partners in a subdivision project. The broker puts up $2 million for the project and signs an agency contract with the developer giving him the exclusive right to list the finished homes. The broker earns commission on the sale of each home, as specified in the listing agreement, as well as a split of the profits, as specified in the partnership agreement. Because the broker made a financial investment in the project, the developer partner cannot terminate the agency relationship.

It is also important to note that the death, incompetency, or bankruptcy of the principal does not terminate an agency coupled with an interest.

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**Challenge Activity**

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<td>9. … performing ministerial acts for a customer.</td>
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<td>10. … receiving a higher commission by obtaining a higher price for a seller client.</td>
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Summary

1. **Agency** is a *relationship of trust* created when one person (the **principal**) gives another person (the **agent**) the right to represent the principal in dealings with third parties. Agency creates a **fiduciary** relationship. A principal may be liable for an agent’s acts. The scope of authority determines whether an agent is universal, general, or special. A listing agreement gives **actual authority** to an agent, express authority to find a buyer, and **incidental authority** to tell people the home is available. An agent cannot have incidental authority without **express authority**.

2. Basic real estate agency is between a broker and seller or a broker and buyer. The individual a broker enters into a contract with to represent (and owes a fiduciary responsibility to) is the **client** or **principal**; all third parties are **customers**. Under common law, associated licensees are subagents of the broker’s clients. **Dual agency** occurs when a licensee (or a brokerage, depending on state law) represents both buyer and seller in the same transaction. This generally requires the informed, written consent of both parties to the transaction.

3. An agent owes fiduciary duties to the principal. These basic fiduciary duties are **obedience**, **loyalty**, **disclosure**, **confidentiality**, **accounting**, and **reasonable care** (OLD CAR). The duty of **confidentiality** lasts forever, even after the agency relationship terminates. Disclosure is a key responsibility. An agent must be careful to inform the principal of the true property value, all offers to purchase, identity of the buyer, buyer’s financial condition, any commission splitting with other brokers, and the relationship between the buyer and broker. A real estate agent must not conceal material information from the principal or take any secret profits from a transaction. A party may consent and waive certain duties that an agent normally would owe them. This arrangement may be called **transactional brokerage**, **transaction broker**, **facilitational brokerage**, or **non-agency**, among other names.

4. Agents owe duties of good faith and fair dealing to third parties. Sellers and sellers’ agents must tell buyers about known **latent (hidden) defects**, as well as any **patent defects** that could be considered material.

5. Agency can terminate by revocation, operation of law, accomplishment of purpose (the best way), mutual agreement, expiration, or renunciation (R-O-A-M-E-R). Agency ends by operation of law if a party to the agreement dies, becomes incapacitated, goes bankrupt, property is destroyed or condemned, or the broker loses his license. Agency coupled with an interest cannot be revoked, nor terminated by death, incapacity, or bankruptcy of the principal.
Chapter Quiz

1. What is another word for principal?
   A. agent
   B. client
   C. customer
   D. fiduciary

2. J has the power of attorney to care for all aspects of his sister's life while the sister is serving in the military overseas. He handles her bills, signs legal papers, and even takes on the task of selling his sister's house. Which type of agency does this represent?
   A. general agency
   B. limited agency
   C. special agency
   D. universal agency

3. M is a licensee who works for broker C at ABC Realty, Inc. As such, M would be considered what type of agent of the broker?
   A. M is a general agent.
   B. M is a special agent.
   C. M is a universal agent.
   D. M is not an agent of the broker.

4. T signs a contract with XYZ Real Estate to represent her in her search for the perfect house. She intends for the seller to compensate XYZ. What type of agency situation does this represent?
   A. indirect agency
   B. implied agency
   C. express agency
   D. tacit agency

5. E, a potential home buyer, is chatting with a broker. Of the information E shares with the broker, which is LEAST LIKELY to be considered confidential information?
   A. her current address
   B. her reason for house hunting
   C. her price range
   D. the terms of her divorce

6. While on a listing appointment, the licensee dealing with an elderly lady realizes that she would be happy receiving an offer for much less than market value. The licensee decides to make a cash offer for the list price that the seller accepts. The licensee then sells the property for market value. Which duty has the licensee breached?
   A. confidentiality
   B. disclosure
   C. obedience
   D. no breach has occurred

7. A buyer's agent drafted a purchase contract for the transaction instead of using a form. This is MOST LIKELY
   A. legal, although it is discouraged by the National Association of REALTORS®.
   B. legal as long as the seller does not object.
   C. standard practice in most states.
   D. the unauthorized practice of law

8. Licensee Y hosted an open house for a seller client of his brokerage. P went to the open house but declined to enter into an agency relationship. What duty does Y owe to buyer customer P?
   A. honesty
   B. loyalty
   C. obedience
   D. none, she is not his client

9. What duty is an agent of the buyer MOST LIKELY breaching when she appears to be advocating for the seller customer?
   A. disclosure
   B. loyalty
   C. obedience
   D. reasonable care
10. R was the listing agent for T, who countered a buyer’s offer for $5,000 below the list price. The buyer found a different house, and the listing agreement expired. Now T’s house is listed with a different brokerage, and R has a buyer client, J, who wants to make an offer on it. Can R tell J that T would accept $5,000 below list price? Why or why not?
   A. No, R’s negotiations on behalf of former client T are confidential.
   B. Yes, R has a duty to close the transaction as quickly as possible.
   C. Yes, R must act in client J’s best interest.
   D. Yes, R’s relationship with T ended when the listing expired.

11. Of these, which agency termination is due to an operation of law?
   A. The listing broker abandons the seller before the listing period ends.
   B. The listing broker does not find a buyer before the listing period ends.
   C. The listing broker sells the house.
   D. The seller dies before the listing period ends.

12. The signing of what document creates an agency relationship with a potential seller?
   A. agency disclosure form
   B. buyer agency agreement
   C. listing agreement
   D. seller disclosure form

13. Which of these situations would LEAST LIKELY trigger the need to discuss agency relationships?
   A. a home show when someone stops by the booth and picks up marketing materials
   B. an initial listing appointment where you inspect the property and start to learn about the seller
   C. an open house when a prospective buyer begins to express serious interest in the property
   D. in your office when a man comes in off the street and asks to look at one of your listings

14. Broker G appoints licensee T work with a seller client, and licensee J to work with the buyer client in the same transaction. T and J are MOST LIKELY ____________ agents.
   A. delegated
   B. designated
   C. dual
   D. single

15. A licensee MOST LIKELY performs ministerial acts for her
   A. broker
   B. client.
   C. customer.
   D. fellow licensee.

16. Which agency relationship MOST LIKELY requires the written consent of both parties to the transaction?
   A. buyer’s agency
   B. designated agency
   C. dual agency
   D. seller’s agency

17. Client Q tells listing agent D not to disclose the fact that, during heavy rains, water seeps into the basement through small cracks in the walls. D must
   A. disclose the defect to any interested buyers.
   B. give up the listing.
   C. not disclose the defect, due to the duty of obedience.
   D. only show the property on sunny days.

18. What is the name of the 1996 federal law that requires states to develop a procedure to notify community residents of sexual offenders living in their area?
   A. Adam’s Law
   B. Amber’s Law
   C. Casey’s Law
   D. Megan’s Law
19. Which of these would LEAST LIKELY be considered a material fact?
   A. current owner believes the house is haunted
   B. nearby factory spewing pollutants into the groundwater
   C. previous termite infestation
   D. warped window frames

20. Licensee K has worked long hours with buyer client P to negotiate an agreement to buy J's house. A day before closing, P tells K that he just lost his job, and he's sure that the mortgage won't close. However, he doesn't want to abandon the deal yet, "just in case." What should K do?
   A. K cannot disclose this information without breaching his fiduciary duty of confidentiality.
   B. K must disclose this information as it is a material fact.
   C. K must follow his client's lawful orders and let things stand for the time being.
   D. K should ask his broker to terminate the agency agreement with P.
Real estate is a business, and as such, there are many critical considerations related to operating a real estate brokerage. Most of the brokerage topics are more relevant to a broker than a new real estate licensee. Recall that, as a licensee, you work under the legal supervisory authority and responsibility of your broker. It is your broker who enters into agency relationships with clients. Still, it’s important that you are familiar with the agreements that create that agency relationship. In this chapter, we’ll look at various types of agency agreements and discuss compensation issues.

After reading this chapter, you will be able to:

- Contrast various types of brokerage agreements.
- Recall criteria related to the payment of compensation to real estate licensees.
- Calculate commission, commission rates, and sales price.

**Key Terms**

- Buyer Agency Agreement
- Commission
- Cooperating Agent
- Exclusive Agency Buyer Agency Agreement
- Exclusive Agency Listing
- Exclusive Buyer Agency Agreement
- Exclusive Right to Sell Listing
- Listing Agreement.
- Multiple Listing Service (MLS)
- Net Listing
- Nonexclusive Buyer Agency Agreement
- Offer of Cooperation
- Open Listing
- Procuring Cause
- Referral Fee
Brokerage Agreements

Brokerage agreements establish the agency relationship between a client and a real estate broker:

- **Sellers** retain the services of a broker through a *listing agreement*.
- **Buyers** retain the services of a broker through a *buyer agency agreement*, sometimes called a buyer representation agreement or a buyer brokerage agreement.
- **Tenants** may retain the services of brokers to find property to rent with a *brokerage agreement*.
- **Landlords** retain the services of a licensed property manager through a *property management agreement*, which is also a type of brokerage agreement. Landlords could also contract with brokers just for the purpose of finding tenants.

**Authority**

Brokerage agreements give a broker the authority to perform specified real estate services on behalf of a client. Even though an affiliated licensee may work directly with the client, the contract is technically *between the broker and the client*. The licensee simply has the authority to execute the contract on the behalf of and under the supervision of the broker.

If the outcome of the agreement between the broker and client is successful, the broker is entitled to a fee or commission for the services performed. The independent contractor agreement between the broker and the affiliated licensee, then, determines how the broker will distribute proceeds to the affiliated licensee involved in the transaction.

If an associated licensee has active listings and decides to leave the brokerage firm, or his affiliation is terminated, it’s important to remember that the *listings stay with that original broker*. If the seller client chooses to sign a new listing agreement with the licensee’s new broker before the original listing agreement expires, that seller could be put in a position of being obligated to two different brokers for a commission.

**Revoking a Brokerage Agreement**

While a client might revoke a brokerage agreement, canceling the agreement before the negotiated expiration date will typically constitute a *breach of the contract terms* and thus violate the broker’s rights. In such a case, a broker may demand compensation for the damages sustained as a result of the early cancellation. For a listing, for example, damages might include marketing and advertising expenses, the value of services rendered (assuming the broker documented them), and reimbursement for other expenses incurred in the process of listing the property.

Brokerage agreements may include a provision that specifically addresses early termination, such as acceptable reasons for termination and/or an early termination fee. Also note that a client can cancel a brokerage contract without risk of damages if the termination is *for cause*, such as non-performance.
Listing Agreements

There are several types of listing agreements. Each type outlines the specific rights and obligations of the parties, including a broker’s right to a commission.

Exclusive Right to Sell

An exclusive right to sell listing agreement is a bilateral contract between a seller and broker that gives the broker the exclusive right to represent the seller in the sale of the seller’s property. The broker receives compensation regardless of who produces a purchaser in accordance with the terms specified in the listing agreement. If the owner happens to sell the property himself or sells through the efforts of another brokerage, the listing broker still has earned a fee.

This type of listing agreement gives the listing brokerage the sole right to market the property and actively promote its sale. Most brokers prefer to use this type of listing agreement, as it provides them with the greatest opportunity to earn commission.

In most states, an exclusive right to sell agreement must be in writing.

Exclusive Agency

An exclusive agency agreement is a bilateral contract that also gives a specific broker the exclusive right to represent the seller in the sale of the seller’s property. The primary difference is that the listing broker receives compensation only if someone other than the seller finds the buyer during the term of the listing agreement. The seller reserves the right to sell the property herself or to sell or lease the property to any persons specifically exempted in the listing agreement.

Open Listing

An open listing is a nonexclusive listing that a seller gives to as many brokers as he chooses; no single agency has an exclusive contract to sell the property. If the property sells, a broker is entitled to a commission only if she is the procuring cause of the sale. To be the procuring cause of a sale, the agent must be primarily responsible for bringing about a sale (e.g., introducing the buyer to a property or negotiating the contract between buyer and seller). The agent’s actions must start a chain of events that result in the sale.

An open listing is a classic example of a unilateral contract. Here, only the seller makes a binding promise, agreeing to pay a commission if the broker is the procuring cause of the sale; the broker doesn’t actually promise to do anything.

Local zoning ordinances could limit the number of signs from different brokerages that a homeowner may place on the property.
Net Listing

A net listing agreement is not technically a listing, but rather a method of compensation. With a net listing, the property owner agrees to accept a stipulated amount, and no less, upon the sale of the property. The broker retains all money over the seller’s net as a commission. Any of the three basic types of listings previously discussed—exclusive right to sell, exclusive agency, and open listing—can be structured this way.

Net listing agreements are either illegal, strongly discouraged, or very rarely used in many states. This is primarily because they could lead to charges of fraud by a seller who may not have understood the listing terms and feels misled by a licensee who suggests a listing price that is well below market value.

Multiple Listing Service

Most brokers use a multiple listing service (MLS). This is a marketing organization whose members are brokers who agree to share their listings by working together. It is not a type of listing. The broker who lists the property generally agrees to share the commission with the broker who sells the property. An advantage for brokers is that they gain access to a lot more properties that they have the potential to sell. Sellers benefit because their property is exposed to a much larger market without going the route of contracting with multiple brokers and open listings.

When a listing broker negotiates any listing agreement, one item open to discussion is whether the property will go into the MLS. If it does, the listing broker completes a worksheet with the required information for that property and submits it to the MLS for publishing.

Although most items in the worksheet are self-explanatory, a licensee should always give clients copies of all documents they sign immediately! Failure to do so could lead to disciplinary action in many states.

Typical Elements in Listing Agreements

Most brokers use a standard listing agreement form created by a state or local board of REALTORS®. Once you’re affiliated with a broker, familiarize yourself with their listing agreements and the requirements of your state. In addition to indicating the type of agreement (exclusive right to sell, exclusive agency, open), a typical listing agreement contains the following elements:

Parties to the Contract

The listing agreement should clearly state the names of all parties to the contract, including the brokerage company name, the broker, and the licensee listing the property, as well as the names of the specific licensees within the agency who are authorized to work with the seller.

When listing a property, licensees must confirm the ownership interests of the property, and so will usually expect to see some sort of evidence. In addition to the deed, other documents that are useful to examine include a tax bill or survey. The best way to understand ownership issues is to order a preliminary title report.
A title company will examine all recorded documents related to the ownership of the property, including deeds, easements, liens, etc. The report will reveal any issues that need to be resolved before the property can be transferred, including the names of all owners who would be required to sign the deed.

In most cases, these would be the same people who would be required to sign the listing agreement. This is especially important in states that recognize spousal rights, such as homestead or dower. When married spouses own the property, both must sign the listing agreement. Even if they are legally separated or divorced, if both names are still on the deed and neither has signed a quitclaim deed to transfer interest in the property to the other spouse, both must sign the listing agreement.

Similarly, it would be necessary to confirm that the party with whom the licensee is dealing has the authorization to engage the brokerage. For example, if engaged by a corporation to represent its interests in the disposition of real estate, licensees need a copy of the board resolution granting the authorization to execute a listing and/or sales contract on behalf of the corporate entity.

**CAUTION:** Remember that a licensee should never give legal advice or act out of the scope of his authority. When necessary, advise clients to seek professional counsel.

### Description of the Property

The contract should contain a description of the property. Normally, this includes the street address and possibly the legal description. Other information that may be noted includes the size of the lot, zoning, tax parcel number, municipality, school district, easements, etc.

### Asking Price

The proposed asking price of the property must also be stated in the contract. When putting a property up for sale, it is ultimately the seller’s responsibility to determine the listing price. Additionally, the seller should understand that the amount they receive will be the gross of the actual sales price minus any property or special assessment taxes due, any outstanding mortgage or deed of trust balances, broker commissions, and other settlement costs or obligations.

### Term of the Contract

Most states require that a contract indicates a specific ending date. As the listing licensee, the broker wants to have this listing period as long as possible, allowing ample time to generate interest, a sale, and ultimately, a commission. But keep in mind, a seller may not want to commit to one brokerage for more than a few months. This is something that both parties can negotiate in the agreement. Generally, a listing agreement automatically expires at midnight on the specified end date, although some states also require that agreements indicate a specific ending time as well.

**In most states, a listing agreement CANNOT include an automatic renewal clause.**
Payment of Broker's Fee

The listing agreement must specify the conditions under which the client pays commission. Most clients will insist the listing agreement state the specific terms by which a broker earns commission, typically when the seller and the buyer complete the sale, not when they sign the purchase agreement. The contract must clearly spell out in writing the amount of the commission, either as a percentage of the sale or a flat fee.

Remember that the seller and broker negotiate the commission rate or amount. It's a violation of federal antitrust laws for brokers to set uniform commission rates. Any discussion of rates among members of competing firms could give rise to a charge of price-fixing.

Fair Housing Statement

A listing agreement should contain an anti-discrimination/fair housing clause acknowledging the prohibition of discrimination against any protected class on the part of a real estate licensee, seller, or lessor. Licensees in every state are frequently disciplined for failing to include anti-discrimination language in a listing agreement. The language should describe the protected classes for that jurisdiction and remind the seller of his duty to obey the law.

With or without a broker, racial discrimination is against the law. On a listing appointment, it is important to review the fair housing language with prospective clients.

When you encounter a seller who says they know the rules but still do not intend to comply, walk away from that listing. Brokers are always liable for fair housing violations.

Other Elements

The inclusion of these elements in the listing agreement itself is generally optional, though some states may require some or all of them:

OFFER OF COOPERATION The seller should indicate whether he is willing to pay a cooperating broker or buyer's broker, and if so, how much. These fees should also appear in the MLS. These are negotiable numbers.

PROPERTY DISCLOSURE In most states, the seller is required by law to complete a standardized disclosure statement listing what he knows about the structure and mechanics of the property, including defects about the property. There is also a required disclosure related to lead paint.

PERSONAL AND LEASED PROPERTY The listing should indicate personal property of the seller that will be included with the sale of the property. If the seller plans to remove anything from the property, that needs to be identified as well. Additionally, any equipment such as appliances, security systems, cable boxes, etc., that the property owner is currently leasing should be outlined in the listing. The seller should make clear that those items do not come with the property, or the prospective buyer must assume payments for the items.

PERMISSION TO ADVERTISE In most states, a broker may not advertise a property nor solicit for prospective buyers or tenants without the express written consent of the property owner. Licensees should discuss a marketing strategy with sellers and include that in the listing agreement.
**Broker Protection Clause**

Most exclusive brokerage agreements contain a broker protection clause that covers a certain period after the agreement expires. A broker protection clause provides that the listing broker is still entitled to a commission if the property sells during a specified timeframe, and the buyer is someone the listing broker or an affiliated licensee negotiated with during the listing term.

In some cases, the language might indicate, “...to whom the broker has exposed the property.”

Courts have held that such clauses are enforceable. The extent of the protection afforded by a broker protection clause varies depending upon the specific language used.

**Specialized Marketing Techniques**

Depending on local customs, licensees may encounter the following:

**Pocket Listings**

A pocket listing is an agency agreement between a seller and a listing broker in which the listing broker does not submit the listing to the multiple listing service, place yard signs, nor advertise the listed property, except perhaps in very limited outlets. Instead, the broker markets to the property directly to a select group of buyers and brokers. A pocket listing could be an exclusive listing agreement or an exclusive right to sell listing agreement. Pocket listings are more common with high-end properties, unusual properties, or properties owned by well-known figures.

The purpose of a pocket listing generally is for the privacy of the seller. It may be that the seller does not want neighbors or the general public to know the house is for sale. The seller might want to limit access to the property to pre-qualified, serious prospective buyers and deter curious strangers coming to an open house or showing. Or, the seller might not want photographs of their property appearing in online home-selling sites.

Another legitimate reason for a seller to consider a pocket listing is to test the market, to allow the seller to get a good understanding of the market value of the property without having to show a history of price reductions, which would be evident for a property listed in the MLS. A pocket listing could protect the value of a property that would otherwise be in the MLS for an extended period.

One of the concerns about a pocket listing is the possible appearance of illegal discrimination. In theory, a seller and listing broker intent on keeping certain protected classes out of the property could use a pocket listing to screen prospective buyers and limit exposure to the general public. Of course, real estate agents have a fiduciary to follow the legal instructions of their clients. If a seller chooses to opt out of including the home in the MLS or wants to limit marketing of the home, this should be expressly indicated in the listing agreement.

**“Coming Soon” Listing**

A “coming soon” listing is a property that is not officially on the market but is expected to be listed for sale in the multiple listing service within a short period of time, for example, 30 days. In most cases, the sellers are serious about putting the home on the market but might want that extra time to make repairs or renovations, stage the home to show better, find another property, or any other tasks needed to prepare to sell.
Before a broker with a coming soon listing places a yard sign or enters the property as a pre-listing in any online websites, there should be a signed listing agreement in place, which includes the informed, written consent of the seller for any advertising.

“Coming soon” can generate interest and excitement, making the house seem like an “exclusive.” This could give savvy buyers an edge when the property is officially listed for sale. One of the challenges with coming soon listings, however, is to ensure that all prospective buyers have a fair opportunity to view and consider the property and that access to the property is not restricted to a select group of buyers.

Furthermore, many agents think that coming soon listings pressure buyers to deal directly with the listing agent, cutting buyer’s agents out of the transaction and leaving the buyer with no representation or setting up a dual agency situation.

Some local multiple listing services forbid the use of coming soon listings. Make sure you know the rules in the jurisdictions in which you practice.

Buyer Agency Agreements

A buyer agency agreement creates an agency relationship between a buyer and a broker in a real estate transaction. This document—which may also be called a buyer representation agreement, a buyer brokerage agreement, or a buyer listing, among other things—is a written agency agreement between a buyer and a real estate broker stipulating the broker earns commission when the buyer purchases real estate. This agreement primarily does two things:

- Grants the designated broker the right to represent the buyer in the purchase or lease of property.
- Makes the buyer responsible for seeing that the broker is compensated.

As with listing agreements, most states require buyer agency agreements to state a specific termination date and contain an anti-discrimination/fair housing clause.

Exclusive Buyer-Agency Agreements

Just as there are two types of exclusive listing agreements with sellers, there are two types of exclusive buyer agency agreements that provide for compensation to the buyer’s broker:

- An exclusive buyer agency agreement provides that the broker earns the negotiated fee even if the buyer purchases property through another brokerage or finds a similar property herself (similar to the exclusive right to sell listing).
- An exclusive agency buyer agency agreement limits the buyer to representation by a single brokerage; however, the sponsoring broker earns the negotiated fee only if the broker finds a suitable property that the buyer eventually purchases (similar to the exclusive agency listing).

Generally speaking, an exclusive buyer agency agreement must be in writing.
Nonexclusive / Open Buyer Agency

As with an open listing agreement, a nonexclusive buyer agency agreement or open buyer agency agreement allows the buyer to enter into any number of brokerage agreements. A broker earns a commission only if his brokerage is the one that introduces the buyer to the property he purchases.

While it is true the level of fiduciary duty owed to a buyer is the same in both exclusive and nonexclusive buyer arrangements, the level of service and diligence usually provided in such scenarios is amplified when an exclusive agreement is in place. For example, the exclusive buyer broker may extend his property search for the buyer client beyond listed properties, such as properties offered for sale by owner (FSBO).

Compensation

Commission is the primary source of compensation for the real estate licensee. It is typically a percentage of the transaction amount, although compensation could be a flat fee, hourly rate, or some other consideration. When drafting an agency agreement, the client and the broker negotiate the commission rate. One important thing to reiterate about that negotiation process is that whatever terms the broker and client agree to should be clearly spelled out in writing.

Although a broker may have a standard commission rate that he wants to charge as a company policy, it's up to the broker to determine how much he is willing to negotiate with a client. Some brokers refuse to lower their standard commission; others may be willing to accept less commission under certain circumstances. It's entirely up to the broker to set a commission policy that he is willing to accept.

Any mention of specific commission rates in this chapter is strictly for purposes of education and illustration. There are NO minimum or standard commission rate agreements between competing brokers or members of a multiple listing service, as that would be a violation of federal antitrust laws.

Timing of Commission

The agency agreement should not just document the amount of commission, but the timing at which it will be paid. Payment of a broker's commission may be dependent on any lawful condition. For example, a listing agreement may specify that commission is due once the seller signs a binding contract with a buyer, or only if a sale closes. Of course, this is also a negotiable point in the brokerage contract.

Unless otherwise agreed, however, the traditional consensus is that a listing broker is entitled to a commission when there is a ready, willing, and able buyer, and a meeting of the minds occurs between the buyer and the seller on all terms.

Ready, Willing, and Able

A buyer is considered ready and willing if she makes an offer that meets the terms established by the seller in the listing agreement. A buyer is considered able if she has the financial ability to complete the purchase. Under the terms of most listing agreements, once a ready, willing, and able buyer has submitted an offer and the seller has agreed to it, the broker has earned a commission—even if the sale never closes.
If a buyer’s offer doesn’t exactly match the terms the seller specified in the listing, the seller can refuse to contract with that buyer, without owing the listing broker a commission. This makes it very important to have the seller’s terms clearly defined in the listing agreement.

**Opportunities for Commission**
Commission does not come only from sellers to listing brokers, however, even though that is the most common source. Other ways in which commission may be earned include:

- A buyer signs a buyer-agency agreement that includes commission.
- A seller authorizes the listing broker, in the listing agreement, to make an offer of compensation to cooperating brokers through the multiple listing service (MLS).
- A property manager meets certain contractual obligations as spelled out in the property management agreement and receives compensation for providing the agreed-upon services.
- A commercial tenant signs a long-term lease, and the property owner pays the listing broker a commission as indicated in the listing agreement.

**Compensation for Buyer’s Agents**
A buyer could negotiate to have the seller pay all or a portion of the buyer’s broker commission. For example, the buyer agency agreement might state that the buyer will get credit for any commission the seller pays a buyer’s broker through an MLS offer of compensation. If the buyer agreed to pay his broker 4%, for example, and the listing broker agrees to pay 3% to a buyer’s broker, the buyer would be obligated to pay only the 1% difference.

Such a clause in the agreement does NOT create an agency relationship between the buyer and the listing broker, nor does it create a subagency relationship between the listing broker and the buyer’s broker.

**Referral or Finder’s Fees**
Another opportunity for compensation could come from referral fees, sometimes called finder’s fees, where one broker pays another broker for directing a buyer or seller to a real estate agent in that brokerage.

While brokers may not pay a referral fee to an unlicensed person, they may be able to pay a referral fee to another broker who is duly licensed in their state or who holds an equivalent real estate license in another state or country. Generally speaking, brokers may pay referral fees only when there is reasonable cause for payment, for example, an actual introduction of a client has been made to a licensee. The mere fact of reasonable cause, however, does not legally obligate a licensee to pay a referral fee to another licensee.

Most states require the referral fee agreement to be in writing to be enforceable.
Eligibility for Commission

Here are some key points to remember about the payment of commission:

- To be eligible for a sales commission, an individual must have an active real estate license and be affiliated with a broker.
- A licensee can receive the agreed-upon share of the commission only from her broker.

An exception is that a licensee may be able to receive commission from a former broker if the licensee was licensed under that former broker at the time commission was earned. This may be referred to as a dangling commission. The agreement that a licensee has with her broker should clearly spell out whether she is entitled to a commission for pending transactions after departing the brokerage.

Calculating Commission

Whatever the terms of the agreement, licensees will want to calculate the commission she hopes to earn. Some people like to use a method known as Circle-Math (or T-Math) for solving problems dealing with percentages, such as commission. Although you can always use the straight-line approach to solving mathematical problems, Circle-Math is a simple way to break down calculations into a few easy steps. You can use this method with any three-part formula, as illustrated here with the three factors common in all percent problems: Part, Percent, and Total (or Whole). The horizontal line indicates division and the vertical line indicates multiplication.

\[
\text{Commission Rate (Percent) x Sales Price (Total)} = \text{Commission (Part)}
\]
\[
\text{Commission (Part)} ÷ \text{Commission Rate (Percent)} = \text{Sales Price (Total)}
\]
\[
\text{Commission (Part)} ÷ \text{Sales Price (Total)} = \text{Commission Rate (Percent)}
\]
For Example

A house sells for $379,000. The listing agreement indicates the seller will pay 6.5% of the sales price as commission when the transaction closes. How much commission does the seller owe?

\[
$379,000 \times 0.065 = $24,635
\]

ABC Brokerage earns $20,230 commission on a $289,000 sale. What was the commission rate?

\[
$20,230 \div $289,000 = 0.07 \text{ or } 7\%
\]

XYZ brokerage earned 7.25% commission, or $16,522.75. What was the sales price of the house?

\[
$16,522.75 \div 0.0725 = $227,900
\]

Commission Schedules

While some brokers may set commission based on flat fees or percentage, other brokers choose to negotiate their fee based on a commission schedule whereby the commission percent decreases as the sales price of the home increases. For the sake of illustration: ABC Brokerage offers a blended rate for more expensive homes.

For a $1 million house, ABC’s blended rate might look like this:

- A 7% commission on the first $300,000 (which is $21,000)
- A 6% commission on the next $200,000 (which is $12,000)
- A 5% commission for any amount over $500,000 (which is $25,000).

This adds up to a $58,000 commission on that $1 million house. The blended commission rate would, therefore, be 5.8% of the sales price.
Commission Splits

In addition to determining the range for the commission it wants to see on a given transaction, a broker also sets policies on how to split the commission with its affiliated licensees. The broker should include the negotiated commission split in the licensee’s independent contractor agreement.

As an example, if a broker offers a 60%-40% commission split to her affiliated licensees, the first number represents the amount the licensee receives, and the second number represents the amount the broker receives.

Commission to Cooperating Brokers

The listing broker also negotiates with the seller to determine how much of the commission, if any, the seller is willing to pay a selling or buyer’s agent. It’s common for a listing broker to include such an offer of cooperation in the multiple listing service (MLS). Brokers who are members of the MLS can then see how much they could expect to earn from the seller if they procure a buyer for that property.

As an illustration, a broker and seller negotiate a total commission of 7% with an offer of cooperation of 3%. When the property sells, the listing broker’s share would be 4% of the sales price; a cooperating broker would receive 3%.

While it’s certainly appropriate for a listing broker to accept the entire earned commission and distribute the agreed-upon split to a cooperating selling broker after closing, in today’s real estate market, it’s common for the commission due both the listing broker and selling broker to be cut directly from the proceeds of the sale at the closing. Thus, both brokers would be paid separately at settlement.

Challenge Activity

Use the appropriate formula to solve commission-related problems.

1. Uptown Realty sold a listing for $234,500. If they charged a 6.5% commission rate, what commission would they earn?

2. A property sold for $1.2 million and the seller paid a commission of $54,000. What rate of commission did the seller pay?
Challenge Activity (cont.)

3. A broker served as both listing and selling broker on a recent transaction. The brokerage charged 6.75% commission and earned a total of $38,137.50 on the sale. What was the selling price of the home (rounded to the nearest dollar)?

4. A brokerage listed a property for $100,000, and a cooperating brokerage found a buyer, who paid $90,000. If the commission rate was 6% and the brokerages split evenly, how much did each company receive?

5. An agent receives a commission of $7,420, which is his half of the total commission. The sales price of the property was $237,440. What rate of commission did the broker charge?

6. A selling agent receives 60% of the brokerage fee from the sale of a property. The property sold for $424,600. The fee is 6% on the first $300,000 and 7% on the remaining amount. What commission will the selling agent earn?

7. A property sold for $390,000. The total sales commission was 6%. Of this 6% commission, half will go to the listing brokerage; half will go to the selling brokerage. The selling brokerage has a 70%-30% split with its licensees. How much commission will the selling agent earn?

8. ABC Realty just sold one of its own listings, a $426,000 sale at 7% commission. In such cases, ABC splits commission as follows: The listing agent keeps 40%, and the selling agent and the brokerage split the remainder evenly. How much will agent B earn if she was both the listing agent and the selling agent on the transaction?
Commission Disputes

When a dispute between licensees occurs over who has earned the commission, the brokers may agree to submit to an arbitration hearing with a disinterested third party. (This method of handling disputes is required of real estate licensees who are members of their local board of REALTORS®.)

The primary objective of an arbitration hearing is to determine which broker initiated the series of events and followed through, resulting in the sale of the property, in other words, who was the procurring cause of the transaction. In the arbitration hearing, the panel will look at all the circumstances, consider the actions of each broker, and determine who has the stronger claim to the commission. They consider many questions when determining the procurring cause:

- Did the listing broker make an offer of compensation?
- Did the initial licensee make reasonable efforts to develop and maintain an ongoing relationship with the buyer?
- Did the licensee who initially introduced the buyer to the property engage in conduct (or fail to take some action) that caused the buyer to seek assistance from another brokerage?
- Did the second licensee wrongfully interfere with the first licensee’s relationship with the buyer?
- How do the efforts of one licensee compare to the efforts of the other?
- Was either licensee aware of the other licensee’s role in the transaction?
- Did each licensee fulfill her fiduciary obligations to the client?
- What was the length of time between each licensee’s efforts and the final purchase agreement?
- Did either broker have a buyer-broker agency contract with the buyer?
- Why did the buyer make the offer to purchase through one licensee rather than the other?

It’s so important to keep good records that illustrate the natural flow of events leading to a real estate transaction. Often, the licensee with the most reliable records will prevail in a dispute.
Summary

1. Brokerage agreements are contracts that establish the agency relationship between a client and a real estate broker. Affiliated licensees have the authority to execute the contract on behalf of and under the supervision of the broker. Brokerage agreements include listings (seller and broker), buyer agency agreements (buyer and broker), brokerage agreement (tenant and broker), property management agreement (landlord and broker). In most states, brokerage agreements must have an expiration date.

2. Each type of listing agreement outlines the specific rights and obligations of the parties, including a broker's right to a commission. An exclusive right to sell listing agreement gives the broker the exclusive right to represent the seller in the sale of property, giving the broker the greatest opportunity to earn commission. An exclusive agency agreement also gives a specific broker the exclusive right to represent the seller in the sale of property, although a seller owes no commission if he sells the property himself. An open listing is a nonexclusive listing a seller has with many brokers as he chooses. A net listing is not technically a listing agreement, but rather a method of compensation. With a net listing, the property owner agrees to accept a stipulated amount, and no less, upon the sale of the property. Net listings are illegal or discouraged in some states.

3. Each buyer agency agreement outlines the parties' specific rights and obligations, including a broker's right to a commission. An exclusive buyer agency agreement provides that the broker earns the negotiated fee even if the buyer purchases property through another brokerage or finds a similar property herself (similar to the exclusive right to sell listing). An exclusive agency buyer agency agreement limits the buyer to representation by a single brokerage; however, the broker earns the negotiated fee only if she finds a suitable property that the buyer eventually purchases (similar to the exclusive agency listing). A nonexclusive buyer agency agreement (also called an open buyer agency agreement) is one in which the buyer enters into any number of brokerage agreements, owing commission only to the brokerage that introduces the buyer to the property purchased.

4. Commission is the primary source of compensation for the real estate licensee. It is typically a percentage of the transaction amount, although compensation could be a flat fee, hourly rate, or some other consideration. Broker and client negotiate payment of a broker's commission. Setting uniform commission rates is a violation of federal antitrust laws.

5. To be eligible for a sales commission, an individual must have an active real estate license and be affiliated with a broker. A licensee can receive the agreed-upon share of the commission only from her broker.
Chapter Quiz

1. What is the most common way to create an agency relationship between a home seller and a broker?
   A. buyer broker agreement
   B. by implication
   C. listing agreement
   D. oral contract

2. You are currently associated with Ace Realty. They recently changed the commission structure and so you’re looking for a new broker. You decide to go to work for Tip Top Real Estate. On your last day at Ace, you have three active listings. What happens to them?
   A. Ace can agree to sell the listings to Tip Top.
   B. Ace has the option to let you take the listings with you if you agree to the commission split.
   C. The listings remain at Ace.
   D. You can take them with you to Tip Top.

3. Seller S calls a real estate agent to list his home. S tells the agent that he wants $156,000 in his pocket at closing and the agent can have the rest for the commission. What type of listing would this be?
   A. exclusive agency
   B. exclusive right to sell
   C. net listing
   D. open listing

4. A seller lists her house with New Age Realty. The next day, she goes to work and mentions listing her house. A co-worker expresses interest in the listing. Which listing would entitle the broker to a commission if the co-worker makes an acceptable offer to the seller?
   A. exclusive agency
   B. exclusive right to sell
   C. net listing
   D. open listing

5. A seller who lives in a small town has posters made up advertising his house for sale. He posts them on telephone poles around the neighborhood. On the poster, he indicates that he will pay 3% to any broker who brings him a buyer. What type of listing might this be considered?
   A. exclusive agency
   B. exclusive right to sell
   C. net listing
   D. open listing

6. J lists his home with PDQ Realty, allowing them to put a sign in the yard, list it in MLS, and advertise it in the local newspaper. During the listing period, J sells the home to his brother and is not obligated to pay PDQ any commission. What type of listing did J have with PDQ?
   A. exclusive agency
   B. net listing
   C. nonexclusive right to sell
   D. open listing

7. Of these, which is LEAST LIKELY to be negotiable in a listing agreement?
   A. the broker’s cooperation with other brokers
   B. the commissions
   C. whether there is an end date
   D. the scope of activities permitted

8. An open buyer agency agreement means that a broker earns commission
   A. if any broker introduces her buyer client to the property he ultimately buys.
   B. only if her buyer client purchases a property that she has listed.
   C. only if she introduces her buyer client to the property he ultimately buys.
   D. no matter who introduces her buyer client to the property he ultimately buys.
9. A property manager becomes an agent of a property owner by signing a 
   A. listing agreement. 
   B. management agreement. 
   C. power of attorney. 
   D. specialized statement.

10. Broker A lists P’s home for sale on the MLS. There is no offer of cooperation mentioned. Broker J has a buyer client who is interested in P’s home. J presents an offer to P, which P accepts. P is paying 7% commission. How much of the commission must P pay J?
   A. 7% 
   B. 3.5% 
   C. nothing 
   D. impossible to tell

11. Generally speaking, a broker has earned her commission
   A. at the closing table. 
   B. when the listing agreement is signed. 
   C. when a ready, willing, and able buyer is found on terms acceptable to the seller. 
   D. when a sales contract is signed.

12. N just sold her house for $186,000. The commission rate in the listing agreement was 6.5%. How much commission did she owe from the sale of the house?
   A. $7,558 
   B. $11,160 
   C. $12,090 
   D. $28,615

13. Seller L will pay 4% of the sales price of her home to the listing brokerage and 3% to a cooperating brokerage. ABC Brokerage earns $5,340 in commission when its client buys L’s house. Find the sales price of the property (rounded to the nearest dollar).
   A. $76,286 
   B. $104,785 
   C. $133,500 
   D. $178,000

14. Licensee K of listing agency ABC Realty has concluded a lengthy and detailed negotiation with licensee J of buyer agency XYZ Realty. After the closing of this transaction, which is the most likely scenario?
   A. The seller will pay both K and J. 
   B. ABC Realty will pay both K and J. 
   C. XYZ Realty will pay both K and J. 
   D. ABC Realty will pay K; XYZ Realty will pay J.

15. What mandates how much a real estate broker can charge for a commission?
   A. multiple listing service membership regulations 
   B. National Association of REALTORS® bylaws 
   C. state licensing law 
   D. There are no mandates.

16. Broker M listed a property for sale. He negotiated 5% commission on the first $200,000, 4% commission on the next $300,000, and 6% commission on any amount over half a million dollars. The property sold for $600,000. What is M’s commission?
   A. $26,600 
   B. $28,000 
   C. $30,000 
   D. $32,000

17. T is a licensee at Lakeside Realty, where she has a 55%-45% commission split with her broker. Her buyer bought a house for $432,000. The listing broker offered 3% to a cooperating broker. How much did T earn on the sale?
   A. $5,832 
   B. $7,128 
   C. $7,776 
   D. $9,504

18. Licensee M receives a commission of $11,268. He has a 50%-50% split with his broker. The sales price of the property is $375,600. What rate of commission did the broker charge?
   A. 3% 
   B. 4.5% 
   C. 6% 
   D. 12%
19. A homeowner just sold his house for $462,700. His listing agreement with Tops Realty indicates that he will pay 7.5% commission based on the sales price when the transaction closes. Tops is paying 45% of that to selling brokerage Uptown Real Estate. Selling sales associate J gets 60% of Uptown’s commission. How much did J earn?

A. $6,246.45  
B. $9,369.68  
C. $11,451.83  
D. $19,086.38

20. In the multiple listing service, it states that the listing broker will pay 4% to a buyer’s broker. Buyer’s broker S earns a total of $5,660 commission. What was the sales price of the property?

A. $80,858  
B. $141,500  
C. $186,667  
D. $226,400
Federal Fair Housing

Fair and equitable treatment in housing and real estate transactions is a right by law. The United States Congress, the U.S. Supreme Court, states, counties, and municipalities have made it clear that everyone needs to have equal access to housing. This mandate is not optional. While real estate licensees must know what classes the law protects and what conduct violates anti-discrimination laws to avoid potential liability, in a broader sense, real estate licensees have a duty to treat all clients and customers fairly and equally.

After reading this chapter, you will be able to:
• Recall federal fair housing laws and the federally protected classes.
• Identify examples of illegal discrimination.
• Describe ways the government enforces fair housing statutes.
• Recall HUD guidelines for fair housing advertising.

Key Terms
Advertisement
Americans with Disabilities Act (ADA)
Blockbusting
Civil Rights
Disability
Discrimination
Disparate Impact
Disparate Intent
Fair Housing Act
Familial Status
Injunctive Relief
Mrs. Murphy Exemption
Public Accommodation
Reasonable Accommodation
Reasonable Modification
Redlining
Steering
Tester
The Path to Civil Rights

The journey toward equity and fairness in housing opportunities in the United States has not followed a direct pathway. There have been legal advances and reverses in the struggle for equal rights. For more than 200 years, the country has made progress toward the goal of equal opportunity for all people to own real property and live in a home of their choosing, limited only by their own economic circumstances.

After the Civil War, the United States adopted the Thirteenth, Fourteenth, and Fifteenth Amendments to the U.S. Constitution. These amendments were referred to as the Reconstruction or Civil War Amendments. The intent of these Amendments was to transform the country to one where civil liberties were available to everyone, including former slaves and their offspring. These amendments abolished slavery, guaranteed equal protection of the law, and established that men of all races had the right to vote. (Women gained the right to vote in 1920 with the passage of the Nineteenth Amendment.)

Civil Rights Act of 1866

The Civil Rights Act of 1866 was the first major legislation to directly affect equal rights to ownership of real property, passed to implement and enforce the Thirteenth Amendment. The Civil Rights Act declared:

All citizens of the United States shall have the same right, in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property and to the full and equal benefit of all laws and proceedings for the security of person and property, as enjoyed by white citizens.

The Act prohibited racial discrimination in all property transactions in the United States, including real or personal, residential or commercial, improved or unimproved. Note that racial discrimination was later defined to include ancestry as well as color.

There are no exceptions to the Civil Rights Act of 1866.

Significant Supreme Court Cases

Because the Civil Rights Act of 1866 did not include any provisions for enforcement, the reality was that not all citizens were treated equally. Several landmark U.S. Supreme Court decisions have addressed civil rights issues over the years.

- Plessy v. Ferguson (1896). The Supreme Court ruled that companies could segregate people of different races if the accommodations were “separate but equal.” This decision was overturned in 1954 with the Brown v. Board of Education ruling.
- Buchanan v. Warley (1917). The Supreme Court ruled that individuals have the right “to acquire, enjoy, and dispose of his property, which is guaranteed in equal measure to all citizens, white, or colored.” Many people interpreted this ruling to be for government actions only, not private actions such as restrictive covenants.
- Shelley v. Kraemer (1948). The Supreme Court ruled that private restrictive covenants were legal, but a government action could not enforce them. It was an early step toward eliminating housing discrimination by private parties.
• **Brown v. Board of Education (1954).** The Supreme Court concluded that separate educational facilities were inherently unequal, which violated the due protection clause of the U.S. Constitution. This ruling overturned *Plessy v. Ferguson.*

• **Jones v. Alfred H. Mayer Co. (1968).** The Supreme Court made a landmark ruling that upheld the 1866 Civil Rights Act that prohibits racial discrimination by the state and by any private organization. This case ruled that **race can never be an exemption.**

### Federal Fair Housing Act

The federal government passed a series of acts that extended the Civil Rights Act of 1866 and identified additional protected classes. Combined, these came to be known as the federal **Fair Housing Act:**

- **1968—Fair Housing Act.** The first meaningful legislation to address discrimination in the sale and rental of housing, upholding prohibitions against racial discrimination and adding **religion** and **national origin** as protected classes (also referred to as Title VIII of the Civil Rights Act of 1968).

- **1974—Housing and Community Development Act.** Reinforced the federal Fair Housing Act by adding **sex/gender** to the list of protected classes.

- **1988—Fair Housing Amendments Act.** Prohibits discrimination based on **disability** or **familial status** while greatly expanding the enforcement role of the Department of Housing and Urban Development.

The Fair Housing Act applies to most sales, rentals, and exchanges of **residential property.** This includes vacant land if it is offered for the construction of residential buildings. The law also prohibits discrimination in **advertising, real estate brokerage, lending,** and **some other services associated with residential transactions.**

### Protected Classes

The federal Fair Housing Act is the primary legislative act that has had the greatest impact on issues of housing and discrimination. As of today, the federal Fair Housing Act prohibits discrimination in the sale or lease of **residential property** based on these **protected classes:**

- Race
- Sex
- National origin
- Color
- Handicap or disability
- Religion
- Familial status

The federal Fair Housing Act allows states and local government entities to pass laws setting higher standards, such as additional protected classes and restrictions. Make sure you understand your locality’s specific fair housing legislation.

### Familial Status

Familial status refers to:

- Households that include individuals under the age of 18 who either live with parents or legal custodians, or
- Pregnant women or any person in the process of obtaining legal custody of a child under the age of 18.

In effect, the federal Fair Housing Act makes it illegal to discriminate against someone who is a parent or guardian with custody of a child under 18 years old.
Familial Status Exemptions
The 1988 Fair Housing Amendments Act exempts the familial status provisions for housing for older persons, which is defined as housing:

- Provided under a state or federal program designed to assist the elderly.
- Intended for and solely occupied by persons 62 or older.
- Designed to meet the physical and social needs of older persons; if management publishes and follows policies and procedures demonstrating an intent to provide housing for persons 55 or order, at least one person age 55 or older occupies at least 80% of the units, and the facility or community provides HUD with surveys and affidavits confirming the ages of its residents.

If any one of these specific exceptions exists, senior housing facilities and communities can lawfully refuse to sell or rent dwellings to families with minor children or can impose different terms and conditions of residency.

Disability
A disability is defined as a physical or mental impairment that substantially limits or curtails one or more major life activities. The federal Fair Housing Act defines this further:

- Major Life Activities. Functions such as caring for one’s self, performing manual tasks, walking, seeing, hearing, speaking, breathing, learning, and working.
- Physical Impairment. Any physiological disorder or condition, cosmetic disfigurement, or anatomical loss, for example, blindness, hearing impairment, mobility impairment, HIV infection, alcoholism, drug addiction, chronic fatigue, etc.
- Mental Impairment. Any mental or psychological disorder such as mental retardation, organic brain syndrome, emotional or mental illness, and specific learning disabilities.

If a tenant or someone associated with them has a disability, under the federal Fair Housing Act, the housing provider may not discriminate. The landlord must:

- Make reasonable accommodations in rules, policies, practices, or services, if necessary, for the disabled person to use the housing on an equal basis with non-disabled persons. For example, a visually impaired person cannot be prohibited from having a guide dog in a building with a “no pet policy.”
- Allow the tenant to make reasonable modifications to a dwelling or common use areas, at the tenant’s expense, that would permit her full use of the housing. Where reasonable, the housing provider can require the tenant to restore the property to its original condition upon moving.
Sexual Orientation as a Protected Class

While neither the federal Fair Housing Act nor the Equal Credit Opportunity Act explicitly prohibits discrimination on the basis of sexual orientation, the United States Supreme Court in Case No. 14-556 (Obergefell Et Al. v. Hodges, Director, Ohio Department of Health, Et Al. Certiorari to The United States Court of Appeals for the Sixth Circuit) which was decided June 26, 2015, provides that same-sex couples have the same right to marry as opposite-sex couples and cannot be discriminated against due to sexual orientation, essentially rendering discrimination in housing and lending void.

States and municipalities can also pass stricter laws than those imposed by the federal government, and the stricter law prevails. Furthermore, the Code of Ethics and Standards of Practice of the National Association of REALTORS® requires its members to follow all anti-discrimination laws that protect people on the basis of race, color, religion, sex, handicap, familial status, national origin, sexual orientation, or gender identity.

Fair Housing Exemptions

The federal Fair Housing Act defines four specific exemptions that affect all protected classes EXCEPT race or color. Also, recall that the 1866 Civil Rights Act prohibits discrimination based on race or ancestry in any property transaction, regardless of any exemptions available under the federal Fair Housing Act.

A transaction in which a real estate licensee is involved is NEVER EXEMPT.
Also, states and municipalities may have fair housing statutes that do not recognize these federal exemptions. Make sure you know the law in the jurisdictions in which you practice.

Exemption 1: Single-Family Home

The federal Fair Housing Act does not apply to a single-family home that a private owner sells or rents provided that:

• The owner owns no more than three such homes at one time.
• Any advertising used is not discriminatory.
• The owner does not use the services of a licensed real estate professional.

To qualify for this exemption, the owner must meet all three of the above requirements. If the owner isn’t the occupant or the most recent occupant, he may use this exemption only once every 24 months.

Exemption 2: Owner-Occupied

The federal Fair Housing Act does not apply to the rental of a room or unit in a dwelling with four or fewer independent units provided that:

• The owner occupies one unit as a residence (unless the owner is a real estate licensee).
• Any advertising used is not discriminatory.
• The owner does not use the services of a licensed real estate professional.

This exemption is sometimes referred to as the Mrs. Murphy exemption.
**Exemption 3: Operated by Organizations**

In dealing with their own property in noncommercial transactions, religious organizations or affiliated nonprofit organizations may limit occupancy to or give preference to their own members provided that the organization does not restrict membership on the basis of race, color, or national origin.

**Exemption 4: Operated by Private Clubs**

Private clubs with lodgings that aren’t open to the public and that aren’t operated for a commercial purpose may limit rental or occupancy to or give preference to their own members. However, it’s important to note that private clubs may not restrict membership on the basis of race, color, or national origin.

**Discriminatory Activities**

The following are specific activities that violate the federal Fair Housing Act if they use a person’s race, color, religion, sex, national origin, disability/handicap, or familial status as a factor.

<table>
<thead>
<tr>
<th>Violation</th>
<th>Example</th>
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<tbody>
<tr>
<td>Refusing to rent or sell residential property after receiving a good faith offer.</td>
<td>A homeowner decides not to accept the offer after learning that the buyer is Jewish.</td>
</tr>
<tr>
<td>Refusing to negotiate for the sale or rental of residential property.</td>
<td>A listing agent follows his seller’s instructions to not show the house to any Asians.</td>
</tr>
<tr>
<td>Taking any action that would otherwise make residential property unavailable or deny it to any person.</td>
<td>A minority couple tells an agent what they’re looking for in a home. Six listings in the MLS match their criteria, but the agent tells them about only the three that are in neighborhoods with a high population of minorities.</td>
</tr>
<tr>
<td>Using discriminatory advertising or any other notice that indicates a limitation or preference or intent to make any limitation, preference, or discrimination.</td>
<td>A landlord includes the phrase “no children” in an advertisement for an apartment.</td>
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<tr>
<td>Making any representation that property is not available for inspection, sale, or rent when it is, in fact, available.</td>
<td>A landlord tells a potential tenant who has a Hispanic accent that the apartment is already rented but shows the unit to a white man.</td>
</tr>
<tr>
<td>Denying access to a multiple listing service or any similar real estate brokers’ organization or discriminating in terms or conditions for access to the organization.</td>
<td>A local broker’s organization limits membership to suburban brokerages for the purpose of keeping minority inner-city brokerages out.</td>
</tr>
<tr>
<td>Coercing, intimidating, threatening, or interfering with anyone because of her enjoyment, attempt to enjoy, or encouragement and assistance to others in their enjoyment of the rights granted by the federal Fair Housing Act.</td>
<td>A landlord threatens to evict a tenant who files a fair housing complaint.</td>
</tr>
<tr>
<td>Discriminating in the terms or conditions of any sale or rental of residential property or in providing any services or facilities in connection with such property.</td>
<td>A landlord requires applicants to include a deposit, but the property manager does not tell male applicants about the requirement, so the landlord does not process their applications.</td>
</tr>
<tr>
<td>Discriminating against anyone by a lender in making a loan for buying, building, repairing, improving, or maintaining a dwelling, or in the terms of such financing.</td>
<td>A bank charges a higher interest rate to a credit-worthy borrower who wants to buy a house in a minority neighborhood than it charges for an equally credit-worthy borrower in a different neighborhood.</td>
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Steering
The federal Fair Housing Act prohibits “taking any action that would otherwise make residential property unavailable or deny it to any person.” This is commonly known as steering, sometimes called channeling. Steering is defined as directing prospective buyers or renters to or away from specific neighborhoods based on their race (or religion, national origin, or other protected class), to maintain or change the character of a neighborhood.

When real estate agents make assumptions about the types of neighborhoods where their clients would like to live and limit available properties to only those neighborhoods instead of showing all housing options available, they are practicing illegal steering. Licensees should never assume they know what is best for buyers or tenants.

Steering is also prohibited even if requested by the prospective buyer or tenant.

Blockbusting
Blockbusting is inducing or attempting to induce, for profit, any person to sell or rent property based on representations made regarding entry into the neighborhood of persons of a particular race, color, religion, sex, or national origin. Both federal and state laws prohibit blockbusting, which may also be called panic selling or panic peddling.

Before the federal Fair Housing Act, unscrupulous real estate licensees intimidated homeowners into selling their homes by suggesting the ethnic or racial composition of their neighborhood was changing. Homeowners were led to believe their property values would decline, the area would experience higher crime rates, and the quality of schools would suffer. The motive on the part of a licensee was generally profit. Through certain techniques, a licensee would induce property owners to list properties for sale or to sell properties at a reduced price, and then turn around and sell the properties at a higher value. A wide variety of blockbusting techniques appear in case law.

Redlining
Redlining is discriminating against anyone by a lending institution in making a loan for buying, building, repairing, improving, or maintaining a dwelling, or in the terms of such financing or insurance. In most instances, homeowners must obtain insurance and financing to buy a house. Redlining is a refusal to make loans or provide insurance on property located in specific neighborhoods for discriminatory reasons (effectively, drawing a red line around an area on a map).

In the past, many lenders assumed an integrated or predominantly minority neighborhood was a place where property values were declining. Based on that assumption, they refused to make loans there. Since it was almost impossible to get purchase or renovation loans, it was extremely difficult to market, maintain, or improve homes in those neighborhoods, causing values to decline.
Linguistic Profiling
A real estate practitioner who uses a telephone answering machine or voice mail to screen prospects and doesn’t reply to certain people based on their voice, accent, or dialect could be guilty of illegal discrimination. Such response patterns are called linguistic profiling. This practice may also include actions such as discouraging certain prospects, denying that housing is available, or quoting different pricing or terms.

Whenever an individual or agency can document a definite pattern of unequal or biased treatment in the way a brokerage or licensee answers the telephone or responds to voicemail, they can file a formal discrimination complaint.

Discrimination in Municipal Actions
Exclusionary zoning laws are any laws that have the effect of denying housing to minorities or other protected classes. Courts interpret the clause “make otherwise unavailable or deny” in anti-discrimination legislation as prohibiting such exclusionary zoning. Since it’s currently unlikely that a municipality would enact an openly discriminatory ordinance, one thing that may be evaluated when considering a civil rights complaint involves the concept of disparate intent versus disparate impact.

Disparate intent is a calculated decision to treat some people differently than others in a similar situation. A law with disparate impact (also known as disparate effect), on the other hand, may be neutral on its face, but it has a discriminatory effect since it has a greater impact on one group than it has on others. For example, it has been successfully argued in a number of cases that ordinances limiting low-cost housing have a disparate impact on minority groups, in effect excluding them from certain communities.

HUD’s Affirmatively Furthering Fair Housing rule requires municipalities to assess the racial makeup of their communities and evaluate zoning and other land use factors that could contribute to segregated housing. Relying on the doctrine of disparate impact, an intended outcome of the rule is to increase the number of low-income housing options in all communities.

Advertising Practices
In addition to outlawing discrimination in housing, the federal Fair Housing Act of 1968 restricts the publication of any real estate advertising that indicates a limitation, preference, or intent to discriminate based on race or other protected class. This applies to advertising that:

- Contains words, phrases, symbols, or visual aids that indicate a discriminatory preference or limitation.
- Selectively uses media, human models, logos, and locations to indicate an illegal preference or limitation.

Words carry great power to influence and inform, and sometimes, mislead consumers. The misuse of words, even if unintentional, could convey either overt or tacit discriminatory preferences or limitations.

COMMUNITY DESCRIPTIONS Certain catch words or phrases that describe a community have come under scrutiny because some people may consider them to be “code,” for example, “restricted,” “exclusive,” “urban.” HUD guidelines discourage such phrases but indicate that if the word or phrase is simply descriptive, it is acceptable, for example, “gated community.”
PROPERTY DESCRIPTIONS Some common phrases, such as “master bedroom,” could be offensive to some people based on race or on gender issues. Although HUD determined that was simply a description of the property—a bedroom with its own separate bathroom—many real estate licensees prefer to use the term “owner’s suite” or something similar. Similarly, the use of “family room” does not imply anything related to familial status, according to HUD. Nor does “walk-in closet” discriminate against someone in a wheelchair, any more than “great views of the lake” discriminates against someone who is blind or “jogging trails nearby” discriminates against someone who cannot walk.

PROPERTY LOCATION Licensees should be sensitive to the directions they provide to properties for sale or rent, either through the use of maps or written instructions, to avoid any implication of a discriminatory preference, limitation, or exclusion. For example, do not include the proximity of a church, synagogue, mosque, or temple in an ad. Other examples may include references to significant landmarks or neighborhoods based on race or national origin, for example, Chinatown. It would be preferable to indicate the street or intersection.

HUMAN MODELS While words in an ad can be very powerful, they don’t always tell the complete story. For example, an advertisement that includes photographs of human models should strive to include people who reasonably represent majority and minority groups in the target area, both sexes, and, when appropriate, families with children. Furthermore, according to advertising guidelines from the Department of Housing and Urban Development, ads should portray persons in an equal social setting and indicate to the general public that the housing, product, or service is open to all without regard to race, color, religion, sex, handicap, familial status, or national origin, and is not for the exclusive use of one such group. An advertisement should not include symbols or logotypes that imply or suggest membership in a protected class.

Logos, Slogans, and Posters

The federal Fair Housing Act is very clear about its policies and practices, including the use of the Fair Housing logos, slogans, and statements.

All advertising of residential real estate for sale or rent and for real estate financing should contain an equal housing opportunity logo, statement, or slogan as a means of educating the public that the property is available to everyone regardless of race, color, religion, sex, disability, familial status, or national origin. The choice of logo, statement, or slogan depends on the type of media used, and, in print advertising, its size. If other logos are used, for example, the logo for the National Association of REALTORS®, the fair housing logo must be at least equal in size to the largest one.

The Fair Housing Act also requires that a fair housing poster/notice be displayed and maintained at any place of business where housing is offered for sale or rent, and should be “prominently displayed so as to be readily apparent to all persons seeking housing accommodations or seeking to engage in residential real estate-related transactions or brokerage services.” The fair housing poster must contain the verbiage as shown in the sample.

Using the Fair Housing logo, statement, slogan, and poster declares to the public that the brokerage and the licensee subscribe to the principles of good fair housing practices. If authorities investigate a broker or lender for alleged discriminatory acts, they may consider the failure to display the poster and use the logo as evidence of discrimination.
It is illegal to Discriminate Against Any Person Because of Race, Color, Religion, Sex, Handicap, Familial Status, or National Origin

- In the sale or rental of housing or residential lots
- In advertising the sale or rental of housing
- In the financing of housing
- In the provision of real estate brokerage services
- In the appraisal of housing
- Blockbusting is also illegal

Anyone who feels he or she has been discriminated against may file a complaint of housing discrimination:
1-800-669-9777 (Toll Free)
1-800-927-9275 (TTY)
www.hud.gov/fairhousing

U.S. Department of Housing and Urban Development
Assistant Secretary for Fair Housing and Equal Opportunity
Washington, D.C. 20410
Enforcement of the Fair Housing Act

When Congress passed the Civil Rights Act in 1968, they gave the Department of Housing and Urban Development (HUD) the responsibility for administering the federal Fair Housing Act. The 1988 amendments to the federal Fair Housing Act greatly increased the enforcement role of HUD beyond investigation and conciliation and into mandatory enforcement. HUD’s main responsibilities today are fair housing education and enforcement. The federal Fair Housing Act also requires HUD to develop voluntary programs to achieve fair housing goals.

The Office of Fair Housing and Equal Opportunity (FHEO), a division of HUD, is responsible for the administration and enforcement of federal fair housing laws. The FHEO also establishes policies that ensure equal access to housing for all Americans.

Testing

In 1991, the Civil Rights Division of the Department of Justice established a fair housing testing program to objectively compare access and treatment of prospective homebuyers or renters. The method typically involves two teams of testers (also known as checkers) posing as customers or clients with similar housing needs and economic qualifications, but with obvious differences due to inclusion or exclusion from a protected class. After both attempt to secure the same real estate services, the teams can compare notes on specific treatment, for example, which properties the licensee showed them, the quoted list price or rent, and the real estate licensee’s manner, etc.

HUD or another fair housing agency could initiate testing when they receive a specific complaint from an individual who believes he has been unlawfully treated. Testing can also occur as part of an ongoing program of enforcement when a fair housing agency randomly selects a geographic area to test. The federal Fair Housing Act also contains provisions that encourage businesses and organizations to self-test for compliance.

Fair housing compliance agencies believe the importance of providing equitable treatment to all home seekers outweighs the brief inconvenience of a test. Testing can occur at any time and as many times as it takes to investigate a complaint.

Handling Violations

Violations of the federal Fair Housing Act may be handled a number of ways. Any person or entity, such as a community group, can file a complaint through HUD’s Office of Fair Housing and Equal Opportunity (FHEO) within one year after the alleged discrimination. If HUD determines it has jurisdiction over the complaint, it will investigate. If an investigation reveals evidence of a violation, the agency attempts negotiation and conciliation in an effort to obtain voluntary compliance with the Act.

If these strategies are unsuccessful, HUD generally refers the matter to an administrative law judge (ALJ). If the ALJ finds that housing discrimination has occurred or is about to occur, the ALJ can award a maximum civil penalty of $16,000 per violation for a first offense, in addition to actual damages for the complainant, injunctive or other equitable relief, and attorneys’ fees.
CIVIL LAWSUIT An individual can file a civil lawsuit in Federal District Court within two years of the alleged discriminatory incident. If the court determines that there was a violation, it could issue an injunction, which is a court order requiring a defendant to do something or refrain from doing something. For example, a court might order the respondent to rent an apartment to the complainant, attend educational programs about discrimination, etc. Additionally, the court could award actual and punitive damages with no limits.

Generally, only the person injured by the defendant’s actions may bring a civil lawsuit. For the purposes of the federal Fair Housing Act, however, the U.S. Supreme Court has interpreted the concept of legal standing to sue quite broadly. The court has held it is not only the actual buyers and renters who can sue for violation of the Act but in some cases, a fair housing organization or individual tester may also have standing to sue, since it can be said that housing discrimination injures the entire community.

DEPARTMENT OF JUSTICE ACTION The U.S. Attorney General, as head of the Department of Justice (DOJ), may also bring a civil suit in Federal District Court against anyone engaged in an ongoing pattern or practice of discriminatory activities. The court could issue injunctions or impose fines of up to $75,000 for a first violation and $150,000 for subsequent violations.

The DOJ may also bring criminal charges against anyone who uses force or threats of force to deny or interfere with fair housing rights.

<table>
<thead>
<tr>
<th>Who Can Sue for Violation of Laws against Discrimination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prospective Buyer/Tenant</td>
</tr>
<tr>
<td>Tester (Checker)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Who Can Be Held Liable for Unlawful Discrimination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller/Landlord</td>
</tr>
<tr>
<td>Property Manager</td>
</tr>
<tr>
<td>Resident Manager</td>
</tr>
<tr>
<td>Rental Agent</td>
</tr>
</tbody>
</table>

Real Success

To protect yourself against accusations of fair housing violations, treat everyone equally and fairly. Some brokers require their licensees to use a preprinted contact form, such as a “needs and wants” checklist and/or some type of a prospect data sheet to document whom they spoke with, what they discussed, etc. Such a tool can be part of a broader set of written fair housing compliance procedures for the brokerage that, if enforced consistently, can provide protection against discrimination complaints.

Also, keep good records of all meetings, phone calls, appointments, and missed appointments. While you may not be legally obligated to keep notes of every substantive conversation you have, it can be your strongest defense to establish that you gave equal professional service to everyone. If you find yourself being questioned or end up in court, at least you can demonstrate a conscious effort to be fair, open, and honest with all members of the public.
Americans with Disabilities Act

Although the federal Fair Housing Act prohibits discrimination in housing against people with disabilities, Congress further expanded protection with the more comprehensive Americans with Disabilities Act (ADA), which was signed into law in 1990. In 2008, the ADA Amendments Act addressed five general areas, or titles, of service or operation:

- **Title I—Employment.** Ensures equal opportunity for qualified individuals with disabilities in the workplace in job application procedures and hiring; advancement and discharge of employees; compensation; training; other terms, conditions, and privileges of employment.

- **Title II—Public Services.** State and local services and public transportation.

- **Title III—Public Accommodations.** Private entities that own, lease, lease to, or operate a place of public accommodation (includes transportation provided by private entities).

- **Title IV—Telecommunications.** Common carriers engaged in interstate communication.

- **Title V—Miscellaneous Provisions.** This title provides miscellaneous provisions, including minimum guidelines and a technical assistance plan.

Public Accommodations

Of the ADA titles, **Title III** perhaps has had the greatest effect on the lives of disabled persons as it relates to real estate. Title III prohibits discrimination against people with disabilities “with regards to the full and equal enjoyment of the goods, services, facilities, or accommodations.” Essentially, this title requires **public and commercial facilities to be accessible.**

Title III exempts private clubs and places of worship from complying with this law. **Historic buildings** (properties listed or eligible for listing in the National Register of Historic Places) must still comply with Title III to the “maximum extent feasible,” but if adapting the building would destroy its historic significance, then an alternative may be acceptable.

The primary enforcer of the Americans with Disabilities Act is the U.S. Attorney General. The goal of the ADA enforcement program is to work with wrongdoers toward compliance. However, if necessary, the U.S. Attorney General may impose a fine of up to $75,000 for the first violation and up to $150,000 for subsequent violations.

Licensee Responsibility

It is not only your duty as a licensee to provide unbiased service to all customers and clients, but it is also your **legal responsibility.** It’s critical that you understand the federal, state, and local fair housing laws. Your broker will likely have policies and procedures in place to ensure compliance with these laws. If you do not comply with fair housing laws, you—and your broker—may be subject to fines, loss of license, and other legal action.

Complainants do NOT have to prove intent when filing a complaint against a real estate licensee, only that discrimination occurred.
Licensed real estate professionals also have the duty to **disclose fair housing laws** to clients, while being cautious not to practice law as they do so. In many states, contracts that create an agency relationship—such as a listing agreement with a seller or a buyer agency agreement—must carry a statement that indicates the broker and the client will conduct business in full compliance with local, state, and federal fair housing laws.

After you properly disclose the laws governing fair housing to your clients, you have fulfilled your obligation of disclosure. If you later discover you are working with a client or customer who is not willing to abide by fair housing laws, you must inform your broker. You should also inform the person with whom you’re working that your broker may want to discuss the relationship since the government can hold both you and your broker liable for violating fair housing laws.

**Real Success**

Be aware that even innocent comments could be construed as a violation of fair housing laws. Your customers or clients may ask you pointed questions, such as:

- What’s the racial makeup of this neighborhood?
- What’s the dominant ethnicity at the local high school?
- Is there a mosque nearby?
- Is the guy who made an offer on my house an American?

Consider your responses very carefully. You may have no choice but to tell them that you are unable to answer their questions. If appropriate, you can direct them to other resources, such as the local school district office.

Fair housing violations are serious, so much so that they are almost always **excluded from errors and omissions insurance** policies. To protect yourself against fair housing violations, **treat everyone equally and fairly**. Equal service is a basic tenet of the National Association of REALTORS’ Code of Ethics, and it is good business.
**Challenge Activity**

Determine whether the following statements might be considered discriminatory if included in an advertisement. Indicate which protected class could be involved, and provide a possible rewrite if needed.

<table>
<thead>
<tr>
<th>Advertisement</th>
<th>Protected Class</th>
<th>Discriminatory?</th>
<th>Possible Rewrite</th>
</tr>
</thead>
<tbody>
<tr>
<td>Perfect for New Couples</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
</tr>
<tr>
<td>Newly-Installed Wheelchair Ramps</td>
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<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
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<tr>
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<td></td>
</tr>
<tr>
<td>Seniors Only</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
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</tr>
<tr>
<td>Roommate Wanted: Women Only</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt=" Maybe" /></td>
<td></td>
</tr>
<tr>
<td>Near Temple Beth Israel</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
</tr>
<tr>
<td>Apartamento en alquiler</td>
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<td></td>
</tr>
<tr>
<td>Playground Within Walking Distance</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
</tr>
<tr>
<td>Credit Check Required</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
</tr>
<tr>
<td>Chapel on Premises</td>
<td></td>
<td><img src="#" alt="Yes" /> <img src="#" alt="No" /> <img src="#" alt="Maybe" /></td>
<td></td>
</tr>
</tbody>
</table>
Summary

1. The **Civil Rights Act of 1866** prohibits discrimination based on race or ancestry in any personal or real property transaction in the United States.

2. The **Federal Fair Housing Act** (Title VIII of the **Civil Rights Act of 1968**) prohibits discrimination based on race, color, religion, sex, national origin, disability, or familial status in the sale or lease of residential property. It also prohibits discrimination in advertising, lending, and brokerage in residential transactions. Steering, blockbusting, and redlining are among the practices outlawed by the act. **Steering** is channeling prospective buyers or tenants to particular neighborhoods based on race, religion, or ethnic background. **Blockbusting** is trying to induce owners to sell their homes by suggesting the ethnic or racial composition of the neighborhood is changing, with the implication that property values will decline. This is also called **panic selling**. **Redlining** is refusing to make loans on property located in a particular neighborhood for discriminatory reasons. The **Department of Housing and Urban Development (HUD)** enforces the federal Fair Housing laws through civil lawsuits in state or federal court.

3. Certain transactions are **exempt** from the Federal Fair Housing Act, but a person who has been discriminated against on the basis of **race** or **ancestry** in any of those transactions can still sue under the Civil Rights Act of 1866.

4. A seller or landlord who rejects a prospective buyer or tenant has violated **anti-discrimination laws** if the person’s race (or religion, sex, etc.) was a factor in the rejection. Courts can hold almost anyone associated with a real estate transaction liable for fair housing violations; the Supreme Court has held that even **checkers** and **fair housing organizations** have **legal standing to sue** for violations of the fair housing laws. Someone must file a complaint with HUD within one year of the alleged violation. Someone has two years to file a civil lawsuit.

5. A law that is neutral on its face value may have a **disparate impact** on a minority group, thus making it a violation of the fair housing laws. **Exclusionary zoning** ordinances violate fair housing laws because they tend to have a greater impact on minorities and other protected groups. Exclusionary zoning and disparate impact cases usually involve ordinances that prohibit or unreasonably restrict the construction of multi-family or low-income housing, effectively excluding minorities and low-income individuals from some communities.
<table>
<thead>
<tr>
<th>Protected Class</th>
<th>Civil Rights Act of 1866</th>
<th>Federal Fair Housing Act</th>
</tr>
</thead>
<tbody>
<tr>
<td>Race</td>
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<td>X</td>
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<tr>
<td>Color</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Religion</td>
<td></td>
<td>X</td>
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<tr>
<td>Sex</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>National Origin</td>
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<td>X</td>
</tr>
<tr>
<td>Ancestry</td>
<td></td>
<td>X</td>
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<td></td>
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<tr>
<td>Familial Status</td>
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<tr>
<td>Age</td>
<td></td>
<td></td>
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<tr>
<td>Marital Status</td>
<td></td>
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<tr>
<td>Sexual Orientation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Property (Real + Personal)</td>
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<td></td>
</tr>
<tr>
<td>Only Housing + Land for Housing</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Housing + Any Vacant Land</td>
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</tr>
</tbody>
</table>

### Exemptions
- May not be recognized in all states or local jurisdictions
- Transactions involving real estate licensees are NEVER exempt
- Racial discrimination is NEVER exempt

**NONE**
- 1. Owner of single-family home
- 2. Owner-occupied, 4 units or less
- 3. Religious groups
- 4. Private clubs

### Statute of Limitations
- Same as state
- 1 year for a HUD complaint
- 2 years for a civil lawsuit
Chapter Quiz

1. Who would be considered exempt under the Civil Rights Act of 1866?
   A. owner of a two-family dwelling who lives in one unit
   B. owner of a single-family residence
   C. private clubs renting to its members
   D. There are no exemptions.

2. Which ruling by the Supreme Court of the United States upheld the Civil Rights Act of 1866, confirming that one can NEVER discriminate on the basis of race or color?
   A. Brown v. Board of Education
   B. Buchanan v. Warley
   C. Jones v. Alfred H. Mayer Co.
   D. Plessy v. Ferguson

3. H, an Asian-American, tries to rent an apartment in a four-unit building. The real estate broker who manages the building rejects her application because her credit rating is not very good and also because she is Asian. Does the real estate broker’s refusal violate the federal Fair Housing Act?
   A. No, because a poor credit history is a legitimate reason for rejecting a rental applicant.
   B. No, because residential buildings with four units or less are exempt from the Fair Housing Act.
   C. Yes, because credit history is a protected class under the Federal Fair Housing Act.
   D. Yes, because her race was a factor in the manager’s decision, even though it was not his only reason for rejecting her application.

4. What are the protected classes under the federal Fair Housing Act and its amendments through 1988?
   A. age, race, color, national origin, religion, familial status, disability
   B. color, race, sex, age, religion, familial status, sexual orientation
   C. race, color, national origin, religion, sex, disability, familial status
   D. sex, race, color, sexual orientation, religion, familial status, disability

5. Which question would NOT be construed as being discriminatory in nature when asked of a buyer?
   A. Do you have children?
   B. How many bedrooms do you need?
   C. How many family members will be living with you?
   D. What church do you attend?

6. Which household does NOT qualify as a protected class under the federal Fair Housing Act?
   A. grandparents raising their 10-year-old grandchild
   B. pregnant woman
   C. retired couple over 65
   D. single mother with three toddlers

7. V, who is six months pregnant, tries to rent an apartment in a six-unit building with access to a shared swimming pool. The property manager rejects her application, citing insurance liability concerns of having small children in the building. Does his refusal violate the federal Fair Housing Act?
   A. No, because safety is a legitimate reason for rejecting a rental applicant.
   B. No, because residential buildings with six units or less are exempt from the federal Fair Housing Act.
   C. No, because the federal Fair Housing Act doesn’t apply to discrimination by real estate licensees.
   D. Yes, because discrimination based on familial status was a factor in the manager’s decision.

8. It would be a violation under the Fair Housing Act to
   A. refuse to allow a tenant who is blind to have a guide dog in a pet-free building.
   B. refuse to rent a unit in a club-owned building to someone who is not a club member.
   C. refuse to rent a room in your private residence to someone of a different gender.
   D. restrict the number of people living in a single apartment unit.
9. Which is an example of steering?
   A. Agent T tells homeowners that their property values will drop when a minority family moves in.
   B. Mortgage banker B refuses to make loans for a specific inner-city neighborhood.
   C. Property manager A suggests J would be happier in a more diverse building.
   D. Seller O tells his listing agent to find only Caucasian buyer prospects.

10. Which activity is NOT prohibited under the Fair Housing Act?
   A. inserting a provision in a deed limiting the transfer of ownership based on someone’s race
   B. prohibiting a single mother from renting an apartment in a complex with a pool
   C. refusing to enter into a listing agreement with a 17-year-old minority woman
   D. telling someone with an accent that an apartment is rented when it is not

11. A licensee who tells homeowners that property values are declining because the ethnic or racial makeup of the neighborhood is changing could be found guilty of
   A. blockbusting.
   B. disclosure.
   C. steering.
   D. stigmatizing.

12. An individual who is confined to a wheelchair would like to rent an apartment. The individual states that the property would need to be made accessible. Which of the following options would NOT be lawful in this situation?
   A. The landlord makes the renovations but requires the tenant to pay the actual cost of the materials.
   B. The landlord makes the renovations to the property at the landlord's expense.
   C. The landlord refuses to allow the individual to make the renovations to the apartment.
   D. The landlord requires the tenant to make the renovations at the tenant's own expense and requires the tenant to return the property to its original condition at the end of the tenancy.

13. G calls landlord S about an advertised apartment. He told her it was rented. A week later, the sign was still up. G believes S did not show her the apartment because she was a woman and she had a strong accent. If G decides to file a complaint against S with HUD, she must do so within _______ of the incident.
   A. 90 days
   B. 6 months
   C. 1 year
   D. 2 years

14. How long does a claimant have to file a civil lawsuit in Federal District Court for a violation of Title VIII of the Civil Rights Act of 1968?
   A. 180 days
   B. 1 year
   C. 2 years
   D. 3 years

15. L wants to rent out a unit in the four-unit building he owns and lives in. He is 65 years old and is uncomfortable around certain types of people. He hires J, a licensee, to help him. Unknown to J, L puts an ad in the paper that says: “No college students.” This ad is
   A. permitted because “college students” are not a protected class.
   B. permitted but only because L is the one who placed the ad.
   C. not permitted because a licensee is involved.
   D. not permitted because it is discriminatory.

16. In an advertisement for a four-bedroom home, which of the following statements would be considered discriminatory?
   A. beautiful home in an exclusive neighborhood
   B. comfortable home near community recreation center
   C. excellent location; bus stop nearby
   D. large, four-bedroom on a quiet cul-de-sac
17. Q believes that she is the victim of housing discrimination because of her race. Which of the following would NOT be an appropriate action to pursue?
   A. file a complaint with HUD by going to the closest HUD office
   B. file a complaint with a state or local fair housing agency
   C. file a complaint with the local sheriff
   D. file a civil lawsuit in Federal District Court

18. S was interested in renting a unit in an owner-occupied duplex. S called C, a real estate agent, about it who told her that the owner, his client, does not allow children. Who, if anyone, could be held liable for violating fair housing laws in this situation?
   A. the agent only
   B. the owner only
   C. the agent and the owner
   D. the agent, his employing broker, and the owner

19. A mortgage lending company refuses to make loans for homes in a minority neighborhood. This is an illegal action called
   A. blockbusting.
   B. coercion.
   C. redlining.
   D. steering.

20. Agent M of XYZ Realty discloses the fair housing laws to her client; however, the client refuses to show the property to a minority couple. Which action do you think M should take?
   A. M has fulfilled her duty by disclosing the laws to her client; no other action is necessary.
   B. M should contact the couple and inform them of her client’s violation of the fair housing laws.
   C. M should ignore her client’s wishes and show the house to any potential buyer without regard to race, religion, etc.
   D. M should inform her employing broker so that he may determine the method in which to proceed or terminate the listing.
A contract is an agreement to do, or not do, something. It does not have to be a long legal document—a spoken promise, a bus pass, and a movie ticket are all examples of contracts. To be enforced by a court, however, an agreement must be made according to the rules of contract law. Contract law is important to understand because it touches many aspects of real estate as many disputes in a real estate transaction can be tied back to contracts.

After reading this chapter, you will be able to:

• Identify how contracts may be classified and created.
• Describe the process of offer and acceptance.
• Discuss ways to terminate contracts and remedies for breach of contract.

Key Terms

Acceptance    Enforceable Contract    Power of Attorney
Assignment    Executed Contract    Rejection
Bilateral Contract    Executory Contract    Rescission
Breach    Express Contract    Revocation
Cancellation    Implied Contract    Statute of Frauds
Compensatory Damages    Lawful and Possible    Statute of Limitations
Objective    Liquidated Damages    Unenforceable Contract
Consideration    Material Breach    Unilateral
Contingency Clause    Meeting of the Minds    Valid Contract
Contractual Capacity    Novation    Void Contract
Contract    Counteroffer    Voidable Contract
What is a Contract?

Contracts are legally enforceable promises, with the law providing remedies for breach should either party not follow through with the terms of the contract. There are several classifications of contracts:

- The way contracts are created
- The type of promise made
- The status of the contract
- The validity of the contract

These basic classifications of contracts apply whether discussing a listing agreement, a purchase agreement, or any other type of agreement.

Classifying Contracts

<table>
<thead>
<tr>
<th>Classification</th>
<th>Definition</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract Creation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Express</td>
<td>An agreement expressed in words, either spoken or written</td>
<td>Signing a work order at the garage to have your car repaired in exchange for payment is an express contract.</td>
</tr>
<tr>
<td>Implied</td>
<td>An agreement that has not been put into words, but is implied by the actions of the parties</td>
<td>Eating in a restaurant could be an implied contract. It is understood you will pay the bill, even if it is not explicitly discussed with the server before sitting down and eating.</td>
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<tr>
<td><strong>Contract Promise</strong></td>
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<tr>
<td>Unilateral</td>
<td>Only one party makes a binding promise to the other party as an inducement to act, but the second party is not obligated to act.</td>
<td>A reward offered for a missing necklace could be considered a unilateral contract. If someone returns the necklace, the one who made the offer must pay the reward; but the offer of a reward does not obligate the person who found the necklace to return it.</td>
</tr>
<tr>
<td>Bilateral</td>
<td>Each party makes a binding promise to the other.</td>
<td>A sales agreement is a bilateral contract between two parties. The seller agrees to give up possession of the property, and the buyer agrees to pay the specified amount of money.</td>
</tr>
<tr>
<td><strong>Contract Status</strong></td>
<td></td>
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<tr>
<td>Executory</td>
<td>One or both parties have not yet completed performance of their contractual obligations, though they may be in the process of doing so.</td>
<td>A buyer and seller have signed a sales contract for the purchase of property, but the contingencies have not yet been met and the transaction has not yet closed.</td>
</tr>
<tr>
<td>Executed</td>
<td>Both parties have fully performed their contractual obligations (not to be confused with executing a contract, which is merely the act of signing it).</td>
<td>A buyer and seller have met all contingencies of a purchase contract, have gone to closing, and transferred ownership of the property from the seller to the buyer, who is the new owner.</td>
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</tbody>
</table>
# Contract Fundamentals

## Classification

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<thead>
<tr>
<th>Classification</th>
<th>Definition</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Valid</strong></td>
<td>The contract is binding and legally enforceable, meeting all the essential elements for contract formation.</td>
<td>A sales contract that includes all essential elements is valid and binds both parties to the terms of the contract.</td>
</tr>
<tr>
<td><strong>Void</strong></td>
<td>Not enforceable from the outset because it lacks one or more of the essential elements for contract formation or is otherwise defective.</td>
<td>A listing agreement to sell a house that does not include the signatures of both owners of the property and is, therefore, lacking an essential element is void.</td>
</tr>
<tr>
<td><strong>Voidable</strong></td>
<td>One party can choose to disaffirm the agreement without liability because of lack of legal capacity or other negative factor, such as fraud or duress.</td>
<td>A sales contract signed by a minor is voidable by the minor if the minor chooses to dissolve the contract. The other party is bound to the contract if the minor chooses to remain in the contract.</td>
</tr>
<tr>
<td><strong>Unenforceable</strong></td>
<td>A contract that may have been valid between the parties but that a court would refuse to enforce.</td>
<td>An oral contract for the sale of real estate when one party does not follow through or a vaguely worded contract whose intent cannot be established would be unenforceable.</td>
</tr>
</tbody>
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Do not confuse an “executed” contract with the action of “executing a contract,” which is merely signing it. People do say that a signed contract is “executed,” but legally, a contract is executed only after all promises have been fulfilled. It would be more accurate to say that a contract signed by both parties is “accepted.”

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## Contract Formation

For a contract to be valid and enforceable, it must have these essential elements:

1. Mutual agreement (offer and acceptance)
2. Contractual capacity
3. Lawful and possible objective
4. Consideration

A contract could be valid if it contains only elements 1, 3, and 4. To be **enforceable** in court, however, it must contain all four elements. These requirements apply to all contracts. Also, generally speaking, certain contracts—such as those for the sale of real property—must be **in writing** and must be **signed** to be enforceable.

## Mutual Agreement (Offer and Acceptance)

Before any contract can be formed, there must be **mutual agreement**, which generally involves an **offer and acceptance**. Acceptance of the terms of an offer indicates a **meeting of the minds**. In general terms, an offer is one party (the offeror) proposing a contract to another party (the offeree).
To create a binding contract, an offer must be accepted before the offer terminates. When an offer is accepted, a contract is formed and both parties are legally bound. Neither can back out without legal excuse unless the other is also willing to end the contract.

**Contractual Capacity**

**Contractual capacity** (also called contractual ability) is the legal ability to enter a contract. For a contract to be valid, each party must be *legally competent*. This requires:

- **Legal age** of majority (18 years old).
- **Mental** competence (sober, mentally sane, etc.).
- **Proper authorization** (such as signing a contract on behalf of a corporation or other entity).

**MINORS** When an adult enters into a contract with a minor, the contract is *voidable by the minor only*. Even if the minor pretended to be over 18, the minor can disaffirm the contract at any time before turning 18 or within a reasonable time thereafter. The minor may choose to enforce the contract and require the adult to perform. The adult does **not** have the power to disaffirm the contract.

**INCOMPETENCE** If a person has been declared incompetent by a court (because of mental illness, intellectual or mental disability, or senility), any contract he enters into is considered *void* and unenforceable by either party. To be enforceable, the contract would have to be signed by the incompetent person’s court-appointed guardian or someone who has been given power of attorney.

Even if a person has not been declared by a court to be legally incompetent, if it can be proven he was not of sound mind when the contract was signed, the contract may still be voidable by that person. When that occurs, a court may rule in different ways, depending on the circumstances in each case. The contract may be voidable by the incompetent person but, if the other party acted in good faith without notice of the incompetency, a court might decide to enforce the contract.

*i* Only a court can pass judgment on an issue of incompetence. It does not fall to a real estate licensee to make that determination.

**Lawful and Possible Objective**

**Lawful objective** or **legal purpose** means the purpose or objective of a contract must be lawful at the time the contract is made. When one person promises to pay someone for committing an illegal act, the contract is void. A court may also refuse to enforce an otherwise legal contract if its objective violates public policy.

Note that many contracts have more than one purpose and are often **severable**, meaning *one part or provision of a contract can be held unenforceable without making the entire contract unenforceable*. The unenforceable part is severed, or cut, from the agreement, but the rest is enforced.
Consideration

A contract can't be one-way; each party must give something to the other. **Consideration**, also called **valuable consideration**, is anything of value such as money, services, goods, or promises given to induce another to enter into a contract. **Adequate consideration** is something that is comparable in value to the consideration the other party to the contract is giving. A contract could also be formed on **good** consideration, which is nothing more than a promise of love and affection. Consideration can also be a promise to refrain from doing something, in which case it is referred to as **forbearance**.

Consideration is NOT a promise to do something you're already legally obligated to do. Nor is it a promise **not** to do something the law doesn't allow you to do.

In some states, an earnest money deposit given by a buyer with an offer to purchase real property is **not** contractual consideration. It is simply an inducement to accept the buyer's offer and a means of showing that the buyer is serious. In other states, earnest money is **consideration**.

The **adequacy of the consideration** one party gives to the other does **not** have to be equal to the value of what the other gives. In other words, even if one party struck a bad bargain, both still have an enforceable contract. Consideration that is grossly unequal to the value of what the contract is for could be a sign that fraud, undue influence, duress, or a mistake was involved. But the contract is enforceable unless any of these things is proven.

**For Example**

J's house appraised at $200,000. He is eager to sell it quickly because he wants to move to another state to be with his girlfriend. When K offers $75,000 for the house, J accepts, and they execute a written contract. As it turns out, J breaks up with his girlfriend. He wants to back out of the sale, but K will not let him. Although J's house is worth more than twice what K is paying, their contract is binding.

Statute of Frauds

A **statute of frauds** is a state law that **requires certain types of contracts to be in writing and signed to be enforceable** in a court of law. As the name suggests, the writing requirement is intended to prevent fraudulent claims and perjury (false testimony). The parties to an unwritten contract may later disagree about exactly what each agreed to do—or whether they agreed to do anything at all. The statute of frauds provides the remedy for that.

Almost every state has a statute of frauds that requires most contracts for the sale or lease of real property to be in writing and signed. It also generally applies to contracts that stipulate commission is to be paid. An unsigned or unwritten contract is not necessarily invalid, but it would not be enforceable by the courts in the event of a dispute.

**INTERPRETING WRITTEN CONTRACTS** In a breach of contract lawsuit, the court must interpret the parties' agreement and decide if it has been breached. The court tries to decipher and put into effect what the parties intended when they entered the contract.
Generally, when an agreement is in writing, the court is supposed to determine the parties’ intention from the written document alone, and nothing else. This may be referred to as the **four corners rule**.

**Doctrine of Part Performance**

The **doctrine of part performance** allows a court to bypass the Statute of Frauds requirement and enforce an oral contract despite the fact that—because the contract is not in writing—there is no evidence of an agreement between the parties. Even with the doctrine of part performance, a party to the contract is still required to provide evidence of the existence of the contract.

**For Example**

T verbally agrees to sell a house to M on an installment plan. T agrees to give up possession of the house to M, whose performance duty is to pay for the property in incremental payments to T. M has been paying monthly for three years, and T decides he wants the property back. Even though there is no written contract, the court could conclude by the behavior of both parties that a contract did exist.

**Parol Evidence Rule**

**Parol evidence** provides that a written agreement between the parties incorporates and includes all prior and current agreements between the parties—whether those are oral or written—and does not allow for any modifications that would contradict the written agreement.

**Power of Attorney**

A statute of frauds also applies to any power of attorney authorizing someone to sell another’s real estate. A **power of attorney** is an instrument authorizing one person—called an **attorney-in-fact**—to act as another’s agent to the extent stated in the document giving the power of attorney. Unlike an attorney at law, an attorney-in-fact can be anyone. An attorney-in-fact may be a universal or general agent whose authority is restricted to those things specifically stated in the power of attorney.

Often, a power of attorney conferring the right to sell another’s real property must be in writing, signed, witnessed, acknowledged before a notary, and recorded with the county recorder in the county where the land is situated to become effective.

**Offer and Acceptance**

For a contract to be a binding obligation, all parties must consent to its terms. This **mutual agreement**, sometimes referred to as a “meeting of the minds,” is achieved through **offer** and **acceptance**.
Offer

An offer occurs when one party (the offeror) proposes a contract to another party (the offeree). An offer must meet some basic requirements:

- **Intent to Contract.** The explicit words and actions of the person making the offer (the offeror) must reasonably indicate the intention of forming a contract. The intent requirement is concerned with **objective intent** (what the offeror says and does) rather than **subjective intent** (what the offeror is actually thinking). If a person says or does something that a reasonable person could interpret as a serious expression of the intention to make a contract, that may be a legally binding offer—even if the person was just kidding.

- **Definite Terms.** The offer must also have definite terms. An offer is not binding if it is too vague. The offer should state at least such basic items as the subject matter, the time for performance, and the price. In some cases, a court will fill in the blanks with a reasonable time or a reasonable price, but if too many terms are left unspecified, no contract is formed.

- **Communication.** The offer must be clearly communicated to the offeree.

### Presenting Offers

Generally speaking, a licensee has a **statutory duty** to disclose to a seller client all offers to purchase, even if an offer seems unacceptable or if its acceptance would mean a smaller commission. The seller, not the agent, decides if an offer is acceptable.

In some states, a seller may explicitly tell his agent not to present any offers less than a certain base amount, in which case, the agent could legitimately not present a buyer’s offer. Even if allowed, however, the listing broker should have the seller client put this direction in writing as evidence to avoid potential complications with prospective buyers who submit offers below the indicated base.

### Handling Multiple Offers

What happens if an offer comes in after a seller has accepted a previous offer? Does that fiduciary obligation to present all offers end once an offer is accepted? No, it does not. The existence of multiple offers can create a potential legal conflict, however. The concept of **tortious interference** means that you cannot interfere with an existing contract. In other words, you cannot induce a seller client to renounce a signed contract if a better offer comes along.

For example, you present your seller client with an offer that they accept. The next day, another offer comes in that is superior to the first offer, and your client asks you how they can back out of that first offer. That’s when you tell them to contact their attorney. Not only might the first buyer sue them for breach of contract, but the broker for that first buyer has earned a commission for bringing the seller a ready, willing, and able buyer. The seller may be obligated to pay full commission to two buyer’s brokers.
Acceptance

Acceptance is part of the mutual consent needed to reach a “meeting of the minds.” When an offer is accepted, the offeree agrees to the terms of the offer and a contract is formed. At this point, the parties are legally bound; neither can back out unless the other is willing to end the contract. There are four basic requirements for acceptance:

- Only the offeree can accept the offer.
- The offeree must communicate acceptance to the offeror.
- The offeree must accept the offer in the manner specified.
- The offeree must not vary the terms of the offer.

Acceptance Only by Offeree

This may sound obvious, but this is an important consideration. For example, A makes an offer to B to buy his condominium. B rejects the offer. B’s daughter cannot accept the offer on B’s behalf unless she has the legal authority to do so. Similarly, if B mentions the terms of the offer to C, whose condo next door is also for sale, C cannot accept A’s offer and force A into a contract. Of course, A may be willing to work with C, but in legal terms, any contract between A and C is based on a new offer, not on the offer A made to B.

Communicated to the Offeror

One party may have decided to accept an offer, but until that party communicates directly that the offer has been accepted, the offer can be revoked. For example, N offers to buy T’s house. She thinks it’s a good offer and tells her agent that she will accept the offer. Before the agent communicates T’s acceptance directly to N, N changes his mind and can legally revoke his offer.

In the Specified Manner

Many offers specify a certain manner of acceptance (e.g., “in writing,” “via e-mail,” or “by delivering a cashier’s check”). The offeree’s acceptance is not effective unless the offeree follows the instructions in the offer. If the offer states acceptance must be in writing, but the offeree calls and accepts over the phone, it does not create a binding contract; the offeror can still revoke the offer.

When an offer does not specify how it is to be accepted, any reasonable method of acceptance can effectively bind the offeror and prevents revocation. This rule applies to all contracts—even those required by law to be in writing and signed, such as real estate purchase agreements.

No Variance of Terms

To create a contract, the offeree must accept exactly those terms offered. This may be called the mirror image rule. The offeree cannot modify them or add new terms. If an offeree makes material changes to the offer, his or her response is not an acceptance, it is a counteroffer.
Counteroffers

In a perfect world, the seller will accept the offer, and the transaction can move forward. It’s more typical for the seller to reject the original offer and make a counteroffer. A counteroffer represents a change to some of the terms of the original offer, and is, therefore, rejection and a new offer. The original offeror has become the offeree (sometimes called a counterofferor), and the original offeree is now the offeror (sometimes called a counterofferee). A binding contract is not created unless the counteroffer is accepted.

If a counteroffer is rejected, it is too late to go back and accept the original offer. The offeror can start again with a new offer identical to the original one, but if the original offeror has had a change of heart, he can no longer be held to the original offer. This process of negotiation will continue until both the buyer and the seller agree to the terms in the sales contract and all contingencies or clauses are satisfied.

Genuine Assent

Genuine assent means that the parties involved in creating a contract are giving their consent freely. There are situations, however, when the parties are not acting freely:

- **Fraud.** Intentional misrepresentation of material facts or a reckless disregard for the truth. The fraud results in a contract that would not have been completed had the truth been known.

- **Undue Influence.** Excessive pressure on someone, preventing him from making a rational or prudent decision. A contract is voidable if a person is persuaded to sign it by taking advantage of another’s trust or weakness of mind (exhaustion, senility, etc.).

- **Duress.** Threatening violence against or unlawfully confining a person, or any member of that person’s family, to force him to sign a document. Duress can also be a threat of injury to reputation. Economic duress (also called business compulsion) is a threat of taking action that will be financially disastrous to the victim.

- **Mistake.** Occurs when one or more parties to a contract are mistaken about a fact or law. Usually, bad faith and ill will are not involved. If both parties are mistaken about something important to the contract (mutual mistake), either may disaffirm it. If only one party is mistaken (unilateral mistake), the contract is not voidable unless the other party knew of the mistake and did nothing.

Termination of Offers

To create a binding contract, an offer must be accepted before it terminates. Many offers state they will expire at a specified time (e.g., “after five days” or “on March 31”). When an offer does not specify an expiration date, it generally expires after a reasonable time. Even when an offer has an expiration date, it may be terminated sooner by other means.
Revocation

An offer is terminated if the offeror revokes or withdraws it before the offeree accepts it. At the point that the offer has been revoked, the offeree has lost the chance to accept it. This is true even if the offer stated that it was irrevocable or that it wouldn’t expire until a specified date. It’s a different matter if an offeree pays the offeror a sum of money to keep the offer open. Then the offer can’t be revoked during the specified period.

Rejection

An offer is terminated when it’s rejected by the offeree. If A rejects B’s offer on Monday, A can’t change his mind and call B on Tuesday to accept it. If A and B are still interested in the deal, they can start the process of offer and acceptance over again, but B’s original offer was terminated by A’s rejection. If B has lost interest, A can no longer hold B to the offer.

Death, Incapacity, or Destruction

The death or incapacity of one of the parties makes it impossible to form a contract. This would also terminate an offer before a stated expiration date. For example, suppose an offer made on March 1 states that it will expire on March 31. If the offeror dies on March 23, before the offer has been accepted, the offer terminates on that date; it doesn’t continue until March 31. The offeree cannot create a contract by accepting the contract on March 24.

An offer also terminates if the improvements that are the subject of the offer are destroyed by fire or natural disaster.

Performance of Contracts

A contract (real estate or any other contract) creates obligations that must be fulfilled by the parties who entered into the agreement. Once a contract is formed, any number of things can affect how it is carried out, or not carried out. A contract is considered discharged when it is, in some way, terminated. Ideally, a contract is discharged by full performance, which occurs when all the terms of the contract have been carried out.

Assignment or Novation

After both parties sign a contract, one party may wish to withdraw from the obligations of the contract without actually terminating the contract. This may be accomplished through assignment or novation.

Assignment

In an assignment, one of the parties (assignor) transfers rights or interests under a contract to another person (assignee). Generally, either party can assign the contract without the other's consent, unless the contract states that consent is required.

When a contract is assigned to another person, the assignor is not relieved of liability under the contract. The assignor remains secondarily liable to the other party to the contract and can be sued if the assignee does not perform. This rule applies even when the other party consents to the assignment.
Contracts are generally assign able unless the contract explicitly states otherwise. One exception concerns contracts for personal services. Listing agreements, as an example, are considered personal service contracts and, therefore, cannot be assigned.

Novation

Novation is when one party to a contract withdraws and a new party is substituted, relieving the withdrawing party of liability. A novation may involve the substitution of a new party for an original party, or the substitution of a new obligation in place of the original one. For example, if the original parties tear up a two-year lease and execute a five-year lease, that is a novation. Regardless, both parties must give their consent.

Discharging a Contract

While full performance is the best way to discharge a contract, there are other ways a contract may be terminated.

- **Mutual Agreement to Rescind.** Rescission occurs when a contract is terminated and each party gives anything acquired under the contract back to the other party. This occurs when one party to a contract does not want to enforce the other party’s promise. Instead, he just wants to undo the contract and go back to square one. In that case, he may ask a court to rescind the contract. When a contract is rescinded, each party returns any consideration given by the other. This is called restitution.

- **Cancellation.** This involves the termination of a contract without undoing acts performed under the contract. In this way, a contract can be rescinded without going to court. Both parties must agree if they prefer to cancel their contract instead of rescinding it. As with rescission, when a contract is canceled, all further obligations are terminated.

- **Partial Performance.** When both parties agree to accept something different than the terms of the original contract, the original obligation is extinguished. This may also be called accord and satisfaction.

- **Impossibility of Performance.** When the performance of a contractual obligation becomes illegal or impossible because of a change in the law after the contract was created, the contract is terminated.

Breach of Contract

If one party to a contract performs his side of the bargain, the other party is required to perform, too. A breach of contract occurs when one party to a contract fails to perform with no legal cause. The breach does not terminate the obligations of the breaching party. Further, the non-defaulting party may take legal action against the breaching party. Depending on the specifics of the contract, a breach can occur when a party:

- Fails to perform the duties of the contract by the indicated date/time.
- Does not perform in cooperation with the terms of the agreement.
- Refuses to perform the contract.
Material or Substantial Performance

It is not always easy to determine whether a breach of contract has occurred. For example, C does all the things he promised, but A feels they were not done well. Or, C does nearly everything promised, but some details are not finished, and he takes longer to do it than agreed. In these cases, there is room for argument about whether the contract was breached and whether A is required to perform her obligation, which is to pay C. A’s obligation to perform depends on whether there has been substantial performance or a material breach.

- **Substantial Performance.** A promisor does not perform all contractual obligations but does enough so that the promisee is required to fulfill her obligation. If C has not fulfilled every detail of a contract but has carried out its main objectives, then it may be treated as substantial performance. Although A may be able to sue for damages because of the unfulfilled details, she still must perform as agreed.

- **Material Breach.** A breach is material if it is important enough to excuse the non-breaching party from performing any contractual obligations. If C fails to perform some important part of the contract or performs it very badly, it is treated as a material breach. If he commits a material breach, A may be able to sue for damages and be excused from fulfilling her promises.

Contract Clauses

Contracts may include certain clauses and conditions that impact whether a breach is considered material. **Conditions** (sometimes called contingency clauses, subject to clauses, escape clauses, or kick-out clauses) are contract provisions that make the parties’ rights or obligations dependent on the occurrence (or nonoccurrence) of certain events. A contingency protects the person for whom it is written.

Contracts often include one or more contingencies. If the event does not occur, the promisor can withdraw without liability for breach of contract. For example, a purchase agreement may be contingent upon the sale of the buyer’s current home, on the buyer qualifying for financing, or the outcome of a home inspection or appraisal.

When a contract is conditional, the promisor must make a good faith effort to fulfill the condition. The promisor cannot deliberately prevent its fulfillment to get out of the contract. However, a condition can be waived by the party it was intended to benefit or protect.

Timing in Contracts

Some states do not strictly enforce dates and times in contracts unless those dates and times are made to be material in the contract. For example, lacking any special timing provision, a seller may not be able to sell their home to another buyer if the original buyer did not close on the day the contract provided, but rather the next day. Missing the closing date by one day may not be viewed as a breach of contract, and the seller may still be obligated to sell to this original buyer.

**TIME IS OF THE ESSENCE** Many contracts state “time is of the essence.” The purpose of this phrase is to emphasize timely performance as an essential part of the contract, and failure to perform on time is a material breach. If “time is of the essence” is in the contract, the contract may be void as soon as the deadline passes; this is a material breach. The only way to save the contract is for the buyer and seller to agree to extend the contract before the deadline passes.
When a contract does not provide a “time is of the essence” clause, usually performance within a reasonable time after a stated deadline is not a material breach. If the buyer is late in performing, then the seller could give the buyer a reasonable time to perform even though the deadline in the contract has passed. However, the contract is voidable at that point by the seller, and the seller could terminate the contract at any time.

**Tendering Performance**

If a party to a contract sees that the other party is not taking the steps necessary to fulfill the contract, he must offer to perform his side of the deal before suing for breach of contract. So, when a contract is in danger of being breached, the non-breaching party should make what is known as a tender offer, or simply a tender. This is an unconditional offer by one party to perform his part of a contract, showing his willingness to meet the terms of the contract.

**Repudiation**

When a party to a contract clearly and unequivocally states that he doesn’t intend to perform, that party is said to have repudiated the contract. Once one party has repudiated a contract, known as anticipatory repudiation, the other party may immediately file a lawsuit for breach of contract without making a tender offer. For example, B tells A that she is not going to go through with the purchase of A’s property. A does not have to wait until the scheduled closing date nor tender his performance before suing B for breach of contract.

**Responding to a Breach**

If one party to a contract performs badly or refuses to perform, the injured party could choose to take legal action to mitigate the losses resulting from the breach. In a breach of contract lawsuit, the court must interpret the parties’ intentions from the written document alone if possible. Broadly speaking, the main legal remedies for breach of contract are:

- **Suit for Damages.** The injured party can sue for damages. A suit for damages typically involves a request to the court to be financially compensated for harm suffered.

- **Suit for Specific Performance.** The party not in breach asks the court to require the other party to perform as agreed in the contract.

- **Suit for Cancellation.** The party not in breach can bring a suit in court to cancel the contract and ask the court to put the parties back in their original positions.

- **Reformation.** The court modifies a contract to reflect the true intent of the parties. Reformation usually occurs when the parties to the contract enter into it without realizing it contains a clerical error. For example, D was selling a vacant lot and the wrong lot number was written in the contract and nobody noticed the error before the contract was signed.

Every state has a **Statute of Limitations** that provides specific **time limits** within which parties are allowed to bring legal action to enforce their rights under a contract.
Compensatory Damages

Compensatory damages are a damage award, usually monetary, intended to compensate the plaintiff for harm caused by the defendant's actions or failure to act. The most common remedy for a breach of contract is the breaching party is ordered to pay a sum of money to the non-breaching party. The amount rewarded depends on the damage incurred by the non-breaching party. The award amount is supposed to put the non-breaching party in the same position he would have been in if the other party had fulfilled the contract.

For Example

P contracted to clear H's property for $10,000, but he quit the project soon after starting. H then hired L to carry out the job. L charged H $12,000.

H sues P for breach of contract and P is ordered to pay her $2,000. If P had not breached the contract, it would have cost H only $10,000 (rather than $12,000) to have her property cleared. The $2,000 ($12,000 - $10,000) judgment against P represents the difference between what the job actually cost H and what it would have cost her if P had not breached.

If L had charged H only $9,000 to clear the property, H would actually have been better off as a result of P's breach. The job would have cost H $1,000 less than it would have if P had fulfilled their contract. In that case, H would not be entitled to a judgment against P because she was not damaged by his breach. The point of a contract lawsuit is to compensate the promisee for actual damages, not to punish the promisor for breaching.

MITIGATION OF DAMAGES Mitigation is when the non-breaching party takes action to minimize the losses resulting from a breach of contract. The non-breaching party in a contract dispute is required to do whatever he can to reduce the losses or mitigate the damage resulting from the other party's breach.

Liquidated Damages

Liquidated damages are a sum of money that the parties to a contract agree in advance (at the time of entering the contract) will serve as compensation in the event of a breach. A liquidated damages provision is included in some contracts to lessen the possibility of expensive litigation. Since the parties agreed in advance to set the damages at a specified sum, or to calculate them according to a specified formula, the non-breaching party must accept the liquidated damages instead of suing for actual/compensatory damages.

Of course, sometimes the breaching party will refuse to pay, so the case ends up in court anyway. For a liquidated damages provision to be enforceable, it must have seemed likely (at the time the contract was made) that calculating actual damages in the event of a breach would be difficult. If it was apparent that actual damages would be easy to determine, the court may refuse to enforce the liquidated damages provision of the contract and award actual damages instead.

In many states, courts have denied liquidated damages if they are viewed as punitive in nature. Generally, punitive damages are not enforced in contract breach cases, even though the parties may have agreed to the liquidated damages when they signed the contract.
Specific Performance

Specific performance is a legal remedy in which a court orders the breaching party to the contract to perform as agreed rather than simply paying monetary damages. For example, Q enters into a written agreement to purchase E's house at a specific price and on explicit terms. If E refuses to sell, Q may be able to bring suit to force them to sell at the specified price. If the court agrees, it may order specific performance of the contract.

Specific performance is a remedy that is usually available when the contract involves unique goods or other unusual benefits to the other party, and ordinary damages are not a sufficient remedy. Real estate is often the subject of specific performance because, in most cases, each piece of property is unique. One-of-a-kind items such as antiques or items of special personal value may also be the subject of specific performance.

A court can never grant specific performance as a remedy for breach of a personal service contract since no one can be forced to work for someone or to employ someone.

Filing a lawsuit is not the only option for parties involved in contract disputes. The parties can agree to alternative dispute resolution. For example, they could engage a mediator to review a contract dispute or may agree to binding arbitration of a contract dispute.
**Challenge Activity**

Evaluating the situations below and assigning characteristics as appropriate.

<table>
<thead>
<tr>
<th></th>
<th>Unilateral</th>
<th>Bilateral</th>
<th>Valid</th>
<th>Void</th>
<th>Voidable</th>
<th>Unenforceable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Y posts a flyer around town offering a reward of $100 for the return of her lost dog.</td>
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<tr>
<td>2.</td>
<td>L signs a contract agreeing to buy a piece of property from B, but B does not actually own the property.</td>
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<td>3.</td>
<td>In a face-to-face meeting, a farmer offers to pay a roofer $1,500 to install a roof on his barn and the roofer says, “I’ll do it tomorrow.”</td>
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<td>4.</td>
<td>While drunk one night, S and R sign a cocktail napkin stating that R will pay S $25,000 to purchase R’s 1957 Chevy.</td>
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<tr>
<td>5.</td>
<td>D finds a coupon in the paper for $25 off a purchase of $200 or more at the Big Box Store.</td>
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<tr>
<td>6.</td>
<td>K signs a listing agreement with E, promising a 7% commission if she finds a buyer for his house.</td>
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<td>7.</td>
<td>J posts a sign in his yard that says, “Will pay $200 to anyone who paints my deck.”</td>
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<tr>
<td>8.</td>
<td>T tells F that he will buy her house. She tells him that she’ll sell the house to him for $149,000, and they shake on it.</td>
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<tr>
<td>9.</td>
<td>M promises to pay T $10,000 to set fire to M’s house so he can collect the insurance. T agrees and they shake on the deal.</td>
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<tr>
<td>10.</td>
<td>H and her 21-year-old daughter W sign a contract stating H will give W a new SUV if she graduates from college.</td>
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<tr>
<td>11.</td>
<td>P, a 17-year-old college student, signs a lease with property manager G to rent an apartment on campus.</td>
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</tr>
<tr>
<td>12.</td>
<td>Buyer O fills in the blanks on a standardized offer to purchase form, signs it, and gives it to the seller.</td>
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<td></td>
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</tbody>
</table>
Summary

1. A contract is an agreement to do, or not do, something. Every contract is either express or implied, unilateral or bilateral, executory or executed. Contracts are also valid, void, voidable, or unenforceable. The requirements for a valid contract are contractual capacity, offer, acceptance, consideration, and lawful and possible objective.

2. A person lacks the capacity to contract unless he is mentally competent and at least 18 years old. Failure to meet these requirements results in a voidable contract. A valid contract is based on the parties' mutual consent and achieved through offer and acceptance. If the offeree changes the terms of the offer, it is a counteroffer, not an acceptance. If a party obtains another's consent through fraud, undue influence, duress, or mistake, the contract is voidable by the victim. A contract generally is not valid unless there is consideration—each party must give something of value to the other. A contract is enforceable even if the consideration given by the parties is unequal. A contract with an unlawful or impossible objective is void.

3. The statute of frauds requires certain contracts to be in writing and signed to be enforceable. This includes contracts concerning interests in real property: Purchase contracts, options, powers of attorney, and, generally, contracts that stipulate payment of commission.

4. If one party commits a material breach of contract, the other is not required to fulfill his side of the bargain. But when there is substantial performance by one party, the other is also required to perform. A promisor cannot get out of a conditional contract by preventing the condition from being fulfilled. A condition may be waived by the party it was intended to benefit.

5. The most common remedy for breach of contract is compensatory damages. Punitive damages are generally not awarded, except in cases of torts or fraud. The non-breaching party is required to mitigate the damages. A liquidated damages provision states in advance how much one party will be entitled to collect in the event of a breach. Specific performance is available only when a damages award cannot adequately compensate the non-breaching party.
1. M and S enter into a contract stating S will buy M's house for $100,000. Before closing, M learns that S is 17 years old. As a result, M doesn't want to complete the sale. What is the status of this contract?
   A. Contract is void due to fraud.
   B. Contract is void due to S's age.
   C. Contract is voidable by M.
   D. Contract is voidable by S.

2. A and J enter into an agreement wherein A will buy J's house for the asking price if J will install a new roof and if A can qualify for a loan sufficient to cover the purchase. Until the roof is installed and the financing obtained, the contract is said to be
   A. executed.
   B. executory.
   C. rescinded.
   D. voidable.

3. Which is NOT a necessary element for a valid and enforceable contract?
   A. consequence
   B. contractual capacity
   C. lawful and possible objective
   D. mutual agreement

4. Seller B signs the offer from prospective buyer L and hands it back to his broker. What element is missing to make this offer a valid contract?
   A. communication back to the offeree
   B. communication back to the offeror
   C. earnest money deposit
   D. meeting of the minds

5. When B's toy poodle went missing, she tells her neighbor she'll give him $500 if he finds and returns her dog. This is an example of a
   A. bilateral express contract.
   B. bilateral implied contract.
   C. unilateral express contract.
   D. unilateral implied contract.

6. Agent L and client H have just signed an open listing agreement, stating H will pay L 6.5% commission only if L finds a willing and able buyer for her house. What best describes this agreement at this time?
   A. express, bilateral, executed
   B. express, bilateral, executory
   C. express, unilateral, executory
   D. implied, bilateral, executed

7. S was under psychiatric care and declared incompetent by the court. She signed a purchase contract to buy J's house two months later. What was the status of the contract when she signed?
   A. unenforceable
   B. valid
   C. void
   D. voidable

8. M signs a piece of paper promising to clean her mother's house. This is
   A. an express bilateral contract.
   B. an express unilateral contract.
   C. an implied bilateral contract.
   D. not a contract.

9. Upon receipt of an offer to purchase under certain terms, if the seller makes a counteroffer, the prospective buyer is
   A. bound by his original offer.
   B. bound by the agent's decision.
   C. bound to accept the counteroffer.
   D. released from his original offer.
10. B makes an offer to buy W's house. The offer contained a provision limiting the time for acceptance to 48 hours. W immediately rejects the offer as inadequate, and his agent communicates the rejection to B. After thinking about it overnight, W calls his agent again and says, “I've changed my mind. I'll take the offer.” What is the status of B's offer?
   A. It is a binding contract now that W has accepted it
   B. It is still open because B hasn't formally withdrawn it.
   C. It is still open because it still had 24 hours before the deadline.
   D. It was terminated when W first rejected it.

11. J offers E $195,000 to buy her house. She looks at his offer, but will not take less than $198,000. She makes the appropriate correction to the offer and her agent returns the offer to J's agent. E is the
   A. counterofferee.
   B. counterofferor.
   C. offeree.
   D. offeror.

12. Licensee B receives two offers for his seller client's property at the same time: One from another licensee in his office, and one from a cooperating brokerage. What should B do?
   A. submit both offers at the same time, allowing the seller to make a decision after looking at all the facts
   B. submit the higher offer first; if it is not acceptable, submit the other one
   C. submit the offer from his brokerage first and let the seller decide on it before looking at the other offer
   D. submit the offer from the cooperating brokerage first and let the seller decide on it before looking at the other offer

13. What is a state law that requires all real estate contracts to be in writing to be enforceable by the courts?
   A. doctrine of part performance
   B. doctrine of specific performance
   C. parol evidence rule
   D. statute of frauds

14. A condition in a purchase contract states the agreement depends on the property passing a home inspection and radon gas test. This is called a
   A. contingency clause.
   B. counteroffer.
   C. tender offer.
   D. time is of the essence clause.

15. L contracts with H to add a patio to her house, paying him $10,000 for materials now and promising $8,000 for labor when he's done. Before he delivers the lumber, H skips town. L signs a contract with M to do the job, but M charges $20,000. L sues H for breach of contract and is awarded damages. How much is the court MOST LIKELY to award L?
   A. $10,000 compensatory damages
   B. $18,000 liquidated damages
   C. $20,000 punitive damages
   D. whatever L asked for

16. A seller and buyer agree on terms of a purchase and sale agreement and are now waiting for closing to occur. Unfortunately, before closing occurs, a tree falls on the house, destroying the living room. Which is LEAST LIKELY to be one of the buyer’s remedies?
   A. accept the property as is and ask for a reduced price
   B. accept the property and claim the insurance proceeds
   C. require the seller to rebuild
   D. terminate the contract

17. When a court orders someone who has breached a contract to perform as agreed, rather than paying damages, it is known as
   A. full performance.
   B. novation.
   C. reformation.
   D. specific performance.
18. H and O have a valid contract for O to buy H's house. The contract indicates a settlement date of April 30. On April 15, H informs O that she no longer wishes to sell the house. H's action is an example of
A. anticipatory repudiation.
B. partial performance.
C. substantial performance.
D. a tender offer.

19. N has a signed agreement to buy T's car. The day before the title transfer, N calls T and says that he has changed his mind, but his sister F would like to buy the car on the same terms. T substitutes F's name for N's on the sales agreement. This is an example of
A. assignment.
B. novation.
C. rescission.
D. tender offer.

20. Which is an example of liquidated damages?
A. A broker reimburses a former client who sued for breach of agency obligations.
B. A court orders a reluctant seller to pay the commission due to a broker.
C. A court orders a seller to return the earnest money deposit when he backs out of the sale.
D. A seller keeps the earnest money deposit when the buyer backs out.
In this chapter, we’ll examine these common types of contracts that you’ll encounter as a real estate professional:

- A **purchase agreement** is negotiated between an owner of property and a potential buyer, which specifies the terms and conditions for the transfer of ownership.
- A **lease** is negotiated between a landlord and tenant establishing the terms of the tenancy.

Your broker will likely have standardized versions of each of these contracts that you are expected to use, so the discussions here focus on general requirements and elements.

After reading this chapter, you will be able to:

- Describe the purpose of different types of real estate contracts.
- Recall the requirements for a valid lease and compare different types of leases.

**Key Terms**

- As-Is Clause
- Commingling
- Contingency Clause
- Earnest Money
- Escrow Account
- Graduated Lease
- Index Lease
- Land Lease
- Lease
- Lease with Option to Buy
- Lease Purchase
- Lessee
- Lessor
- Mortgage Contingency
- Net Lease
- Option to Purchase
- Percentage Lease
- Purchase Agreement
- Rider
- Right of Preemption
- Sale-and-Leaseback
Purchase Agreements

**Purchase agreements** are contracts in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. In some areas, these may be called purchase contracts, sale contracts, earnest money agreements, and other similar terms. Whatever the name, it is the written agreement between the buyer and seller.

A purchase agreement for real property is the final product of negotiations between the buyer and seller through attorneys or agents representing them and acting on their behalf. While the purchase agreement is the contract between buyer and seller, a real estate licensee should be very familiar with the standard provisions, typical contingencies, riders, and addenda. A licensee also needs to know how to handle a buyer's earnest money.

**Purpose of a Purchase Agreement**

A purchase agreement generally serves these purposes:

- It's the buyer's initial offer (and subsequent counteroffers).
- It's the receipt for any earnest money deposit.
- It's the contract between the buyer and seller.
- It establishes the terms and conditions of the sale.
- It's the document that communicates the details of the transaction to the mortgage lender, title company, and any other party to the transaction.
- It conveys equitable title to the purchaser, which is a limited ownership interest in property created on the execution of a valid sales agreement. Legal title is then transferred by deed at a future date, generally at the closing upon full performance of the contract.

**Standardized Purchase Agreements**

In most states, real estate licensees are not permitted to draft real estate purchase agreements. To do so could be considered the unauthorized practice of law. Therefore, most brokerages require licensees to use their approved, standard disclosure forms and contracts. Today, most residential purchase agreements are created under a cooperative relationship between a local bar association and a local REALTOR® association. Many states limit a licensee's participation in the process to filling in the blanks of the pre-printed contract with facts. If buyers or sellers want to insert any specialized language into the standardized form, it may be necessary to refer them to their attorneys.

**Essential Elements**

There will likely be variations in these standardized contracts to meet specific state requirements to address local custom, but most contain the same essential elements. Ideally, the purchase agreement will state all terms of the sale as clearly as possible, including the following:

- **Parties** to the contract, the buyer(s) and seller(s)
- **Property** to be transferred, which is usually just the address, but may require a full legal description
• **Interest** in the property to be sold, for example, all the bundle of rights, just subsurface mineral rights, etc.

• **Terms** of the sale as clearly as possible; what is and isn’t included in the sale, including personal property

• Total purchase **price** and method of payment, for example, down payment and financing details

• Critical **dates** related to the contract, such as those for clearing contingencies, closing dates, or possession dates

In most states, purchase agreements must be **in writing** and must be **signed** by the buyer(s) and **all owners of the property** that is the subject of the contract to be enforceable.

**Other General Provisions**

The following are among other general provisions that may appear in a purchase agreement (this list is **not** inclusive):

• **Operational Systems.** Seller warranties that the property’s operational systems—such as heating, plumbing, electricity—are in working order at the time of closing.

• **Code Violations.** Seller warranties that the property is not in violation of any property codes.

• **Expiration Date.** Many offers include a “time is of an essence” clause and/or state they will expire at a certain time. Such a clause could void a contract as soon as an indicated deadline by which the terms of the contract must be performed passes.

• **Title Findings.** Directions for delivering acceptable evidence of title are generally included in a purchase contract, as well as obligations for title insurance.

• **Prorations.** In addition to prorating real property taxes, other expenses may be prorated between buyer and seller at closing, for example, utilities, association fees, etc.

• **Communication Requirements.** The acceptable method of communicating the terms of the contract is typically included, for example, whether the contract can be delivered electronically or by mail.

• **Transfer Taxes.** This provision indicates who will pay any required state and county transfer taxes.

• **Flood Insurance.** When a property is located in a federally designated special flood hazard area (SFHA), a lender for federal loans will require a flood insurance policy for the life of the loan in addition to homeowner’s hazard insurance. Purchase agreements may include a statement that flood insurance is the responsibility of the buyer.

A critical element in a purchase agreement is the identification of **personal property** that is to be included or excluded as part of the sale. Since the agreement of sale is the only contract between the buyer and seller, everything included in the listing agreement, the fact sheet, and the MLS listing should be included in the purchase agreement.
Electronic Contracts and Signatures

The Uniform Electronic Transactions Act (UETA) was developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL) to support electronic commerce. This act provides a legal framework for the use of electronic signatures and records in government or business transactions. It establishes that electronic records and signatures are legally equivalent to paper documents and manually-signed signatures, removing barriers to conducting business through electronic means. Most states have their own statutes regarding electronic transactions.

In most cases, the use of electronic records and signatures is acceptable for real estate contracts, although both parties to the transaction must agree to conduct business by electronic means. Once recognized, an electronic record or signature cannot be denied legal effect or enforceability solely because an electronic record was used. Therefore, a broker also satisfies the requirement to retain “original” transaction documents and contracts if they are stored as electronic records and remain accessible for later reference.

Binders

In some markets, or for certain types of transactions, the custom is not to use a standardized purchase agreement. Instead, when a buyer is ready to make an offer to purchase property, the buyer, usually with assistance from a licensee or attorney, completes a simple document called a binder. A binder serves as a roadmap for the creation of a purchase agreement.

The basic information that is contained in a binder looks very similar to the information included on a standard purchase agreement. A binder often includes an earnest money deposit to show the buyer’s good faith in making an offer on the property. It should contain all the essential elements of a contract and is, therefore, legally binding once it is signed. It is then usually the seller’s attorney who writes the actual sales contract.

Earnest Money Deposits

Earnest money is a pledge from a prospective buyer to show that she is serious about an offer. There is no law that sets the appropriate amount of earnest money to be offered in any real estate transaction. As a matter of fact, it is not a requirement for forming a valid contract. Most brokers like to get the largest deposit that a buyer is willing to commit, however, because it usually holds the deal more tightly together.

The earnest money deposit is generally considered to be the liquidated damages paid to the seller if the buyer defaults and the transaction does not close. So, a buyer has a dilemma: A large deposit may induce the seller to accept the offer, but if the deal doesn’t go through because of something the buyer does (or does not do), the buyer could lose that money.

Handling Earnest Money

Almost every state has laws governing the handling of earnest money. Generally, a licensee can collect earnest money from the buyer, but he must immediately turn it over to the broker. A buyer should get a receipt acknowledging that deposit, although the purchase agreement could serve that purpose. If the earnest money is in the form of a check, the brokerage will likely hold it until the offer is accepted. If the offer is not accepted, the broker simply returns the check. When the transaction closes, the earnest money will be disbursed as stated in the purchase agreement.
When an offer is accepted, the earnest money is deposited into an escrow account—also called a trust account—where it remains until the transaction is settled or terminated. State statutes or regulations generally prescribe the timing of the earnest money deposit, for example, within one business day of acceptance. Licensees MUST follow their broker’s policies on turning over funds, which the broker will handle as the law requires.

In most states, it is illegal for a broker to commingle earnest money funds with general brokerage funds. Nor may a broker use earnest money funds for his own uses, an illegal act known as conversion.

Contingencies

A contingency is a way for either party of a contract to get out of the contract due to some circumstance or condition. A contingency makes the residential purchase agreement conditional upon some issue. If the condition is not met, the other party can withdraw without liability for breach of contract. Contingencies—also known as subject to clauses, escape clauses, or kick-out clauses—are important in residential purchase agreements because they limit a buyer’s or seller’s responsibility to fulfill the agreement and close the deal.

For Example

A couple makes an offer to buy a home before they even list their own home for sale. However, they need to sell their present home to come up with the down payment to purchase the new house. So, they make their offer contingent on the successful sale of their current home. Typically, the seller’s house remains on the market while a buyer tries to sell his home. If the seller receives another purchase offer, the first buyer likely has a set time (often only 24 to 48 hours) to agree to remove the sale contingency and proceed with the transaction.

Another buyer may want to make her offer contingent on the home appraising at (or above) the purchase price. Since the lender hires the appraiser, who is independent of the actual transaction, this is another contingency that is considered reasonable. Other typical contingencies that must occur before a contract is formed revolve around inspections, such as a home inspection of a property’s structural integrity (roof, foundation, etc.) and major systems (heating, plumbing, electrical, septic, etc.), inspections for pests, etc.

Financing Contingencies

There are many common contingencies related to financing, for example:

<table>
<thead>
<tr>
<th>Clause</th>
<th>A contingency that the buyer is able to …</th>
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<tbody>
<tr>
<td>Financing</td>
<td>… obtain financing upon agreeable terms, including the amount borrowed, the type of mortgage or deed of trust, the maximum interest rate, the minimum term, etc.</td>
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<tr>
<td>FHA or VA Loan</td>
<td>… obtain an FHA-insured or VA-guaranteed loan commitment.</td>
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<tr>
<td>Loan Assumption</td>
<td>… assume the seller’s loan.</td>
</tr>
<tr>
<td>Seller Financing</td>
<td>… obtain financing from the seller.</td>
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<tr>
<td>Sell Other Home</td>
<td>… sell another home before he is bound to purchase another.</td>
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</table>
Other Contingencies

Other common contingencies may include:

- **Condominium Review Clause.** Allows review and acceptance of the condominium association documents.
- **Inspection Clause.** Relates to systems such as electrical, plumbing, roofing, drainage, heating, air conditioning, etc. and specifies they are in adequate repair and working properly.
- **Walk-Through Clause.** Allows the buyer the opportunity to walk-through the home and accept (or not) the condition and, therefore, the purchase agreement.
- **Absent Party Clause.** Allows the party to accept an offer by telephone or another non-signatory method, and later sign within a fixed timeframe.
- **Wood Infestation Clause.** Gives the buyer the opportunity to have the property inspected for termites and provide options if there are problems.
- **Certificate of Occupancy Clause.** Puts the seller on notice that if the municipality requires a certificate of occupancy, the seller must provide it.
- **Approval of Another Clause.** Allows the buyer to rescind the offer if another named person does not approve, for example, an out-of-town spouse who has not yet seen the property.

Failure to Meet Contingencies

When a contingency written into the sales agreement cannot be met, the typical course of action is to provide some sort of notice of inability to satisfy contingency. Although there is no mandated form, such a notice would likely:

- Provide the reason(s) for not clearing the contingency.
- Declare the sales agreement to be null and void.
- Reiterate the provisions in the sales agreement related to disbursal of any deposit or earnest money funds held in escrow.

Riders and Addenda

**Riders** are simply amendments or addenda to contracts to cover provisions that are not in the standard contract. For example, there may be a rider that outlines specific warranties that accompany the transaction, or an attorney rider that verifies the legality of the contract. Examples of riders include:

- **Short Sale Addendum.** A short sale, or short payoff, is when a lender agrees to accept less than the loan balance when real property is sold. Short sales may take additional time to close because every stakeholder—the lender(s), loan servicer, lien holders, mortgage insurers, securities investors, and possibly others—must decide whether to approve it. Often, offers will expire before the lender responds to the short sale agreement. Therefore, contracts often include an addendum to address the unique conditions of a short sale.

- **FHA/VA Purchase Agreement Addendum.** This addendum includes an amendatory clause that allows the buyer to back out of the contract without penalty if the FHA or VA does not provide a written statement setting the value of the property at or above the sales prices stated in the purchase agreement. The buyer and seller could agree to adjust the sales price in response to an appraised value that is less than the sales price.
As-Is Clause

An as-is clause is a provision in a purchase agreement stating the buyer accepts the property in its present condition. The implication is the buyer has inspected the property and agrees to accept it as is without requiring the seller to fix any problems or renegotiating after the discovery of a problem. An as-is clause does not protect the seller from liability for nondisclosure of latent defects. Also, an as-is clause cannot protect sellers or agents if they deliberately conceal a defect from the buyer. An as-is clause is not a defense to fraud.

For Example

Broker S lists a foreclosed house. For two months, the home has been vacant and the utilities disconnected. Recently, the basement flooded because the sump pump was not connected. The furnace, electrical services, and other mechanical components are in the basement and may have suffered water damage. S cannot protect herself and the seller from potential liability simply by stating to potential buyers the property is sold “as is,” without apprising them of the water in the basement. She must make prospective purchasers aware of the condition, as she is aware of it.

Other Real Estate Contracts

The traditional purchase agreement is not the only vehicle available to address the transfer of interests in real property. Sellers and buyers can explore a variety of alternatives, including options, the right of preemption, and land contracts.

Options

Options are contracts that give one party the right to do something, without obligating him to do it. Thus, an option is a unilateral contract. The most common type of real estate option is an option to purchase. An option to purchase gives one party (the optionee) the right to buy the property of another (the optionor) at a specified price within a limited time. Within that period, the optionee may choose to exercise the option (i.e., enter into a contract to buy the property), but the optionee is under no obligation to exercise the option.

An option is supported by consideration. The optionee pays the optionor for the option right. Once paid, the option money is not refundable, regardless of whether the optionee proceeds with the purchase. If the optionee chooses not to exercise the option to buy, then the optionor may retain the money as compensation for keeping the property off the market and not selling it to anyone else during the option period. In many instances, however, both parties agree that if the purchase actually goes through, the option money will be credited toward the purchase price, much like earnest money in an ordinary purchase agreement.

For Example

If an owner tells a prospective buyer she is willing to sell her house for $100,000, the buyer might pay her $1,000 to keep that offer open for a month. The payment of consideration makes the option irrevocable until it expires. If the optionor dies before the option expires, it is still binding on the optionor’s heirs. If the option expires and the optionee chooses not to purchase, the owner keeps the $1,000.
An option to purchase real property must be in writing and signed. It must also be exercised in writing if the optionee decides to go through with the purchase of the real property under the option. The option agreement should be as specific as possible, stating all terms of the potential sale. The option document may also serve as the purchase contract if and when the option is exercised.

An option can be recorded (to protect the optionee) only if it states a definite expiration date. The optionee’s claim ends automatically on that date, and the recorded option is no longer a cloud on the title.

**Uses for Options**

There are many situations for which an option might be used, for example:

- **Qualifying.** The optionee can’t qualify for a loan now, but believes circumstances will change shortly (e.g., a raise at work), leading to qualification.

- **Time to Acquire Cash.** The optionee needs time to save for the down payment, sell another property, or otherwise get the cash needed to close.

- **Comparison.** The optionee thinks the property is a good deal but wants to investigate other properties before making a final decision.

- **Profit.** The optionee plans to sell the option for a profit (option must be assignable).

- **Speculation.** The optionee thinks the property will increase in value or is perhaps waiting for a zoning change to occur.

- **Investment.** The optionee thinks the property is a good investment but wants to find other investors willing to share the risk.

**Right of Preemption**

A right of preemption is another type of option that gives someone a right to have the first opportunity to buy or lease property if the owner decides to sell or lease it. This is also called a right of first refusal. This is not the same thing as an option. Someone who holds a preemption right, however, has the right to purchase the property before anyone else does only if the owner decides to sell it. Also, if a third party makes a bona fide offer for the property that the owner is willing to accept, the preemption right holder must match the terms of that offer to acquire the property.

**Land Contracts**

Land contracts are real estate installment agreements for which the buyer (vendee) makes payments to the seller (vendor) in exchange for the right to occupy and use the property, but no deed or title is transferred until all, or a specified portion of, payments have been made. Here the seller actually holds title to land as security, not just a mortgage lien. Since actual title will be transferred by deed at a future date, the buyer’s present interest in a land contract is simply equitable title. Land contracts are also known as land sales contracts, installment sales agreements, or contracts for deeds, among other names.

Land contracts are technically a form of seller financing, and so will be discussed in more detail in the Financing Principles chapter.
Leases

Leases are both a conveyance of a leasehold estate from the property owner to a tenant and a contract in which one party pays the other rent in exchange for possession of the real estate. Leases are often called rental agreements.

As a conveyance, a lease temporarily transfers the right of possession of property from the owner (the landlord, or lessor) to another (the tenant, or lessee). Although the landlord still owns the property, the tenant has a leasehold estate. The landlord retains the right to get the property back at the end of the lease (reversionary interest).

As a contract, a lease states the terms of the parties’ relationship. Since the lease is a contract, the four essential elements of a valid contract are also necessary for a valid lease (legal capacity, offer and acceptance, lawful and possible objective, and consideration). In most states, in order to comply with the statute of frauds, a lease must be in writing if it will last for more than one year. An oral lease for less than one year is generally enforceable.

Unlike deeds, residential leases are not typically recorded. However, it’s common—and even required in some states—to record long-term leases, most often commercial leases, with a term greater than three years.

Typical Lease Provisions

Many local REALTOR® associations and multiple listing services provide sample lease forms with generic language. Property owners can also find sample residential leases from online providers or even local office supply stores. While there is no statutory form of a lease, every written lease should include certain basic information:

- A demising clause, which grants possession of the property to the lessee
- Clearly stated terms of the lease, including the duration of the tenancy and its expiration date
- An adequate description of the property, generally just a street address and unit number, if appropriate
- The amount of rent as well as how and when it is paid
- A use provision that asserts the premises cannot be used for anything other than its intended or lawful purpose
- The landlord’s right to access the property during the lease term
- The tenant’s responsibility for alterations or damage to the property
- The consequences of default
- Signatures of both parties (if a written lease)

Some leases also include an option to renew that sets forth the renewal methods and terms of the new lease.

Security Deposits

A security deposit is money the tenant gives a landlord at the beginning of the tenancy to ensure the tenant will comply with lease terms. The landlord may then retain all or part of the deposit at the end of the tenancy to cover unpaid rent, repair costs, or other damages beyond normal wear and tear.
Most states have specific landlord-tenant laws that regulate how to handle security deposits, for example, whether landlords must maintain deposits in a separate escrow account, how to disburse any earned interest, and the timing for the release of the deposit after a tenancy ends. Most states prohibit the **commingling** of security deposit funds with the property owner’s general funds.

A **security deposit** is NOT consideration and is not a requirement for a valid lease.

**Types of Leases**

Leases are usually categorized by the method of rent payment and what is provided in exchange for the rent. Residential leases, for example, tend to be straightforward exchanges of rent for occupancy, and generally are **gross leases**. With a gross lease, *the tenant pays a fixed rent, while the owner or landlord pays all ownership expenses, such as property taxes, mortgage payments, repairs, insurance, etc., and sometimes utilities.* A gross lease is rarely used for commercial properties. Commercial leases are usually more complex and varied in their terms.

<table>
<thead>
<tr>
<th>Commercial Leases</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net lease</strong></td>
<td>The tenant pays some or all of the expenses associated with the property—taxes, insurance, and maintenance/operating expenses—in addition to rent. If the lease requires the tenant to pay one of these expenses, it’s called a single net lease. If the tenant is required to pay any two of these expenses, it’s a net-net lease, or a <strong>double net</strong> lease. A <strong>triple net</strong> lease, or net-net-net lease, requires the tenant to pay all three of these expenses.</td>
</tr>
<tr>
<td><strong>Percentage lease</strong></td>
<td>The tenant pays a percentage of gross sales on the premises, often in addition to a fixed monthly rental payment. This type of lease is most commonly used for retail tenants and may include a clause that allows the owner to reclaim the premises if gross sales fall below a specified point.</td>
</tr>
<tr>
<td><strong>Land lease / Ground lease</strong></td>
<td>A tenant leases unimproved land on a long-term basis; this lease typically includes a provision that provides the tenant will construct a building on the property, which the tenant will own upon completion.</td>
</tr>
<tr>
<td><strong>Index lease</strong></td>
<td>The amount of the rent is tied to some common index indicator such as the Consumer Price Index or the Wholesale Price Index that neither the landlord nor the tenant controls. As the agreed-upon index increases, the rent goes up by the same percentage of change.</td>
</tr>
<tr>
<td><strong>Graduated lease</strong></td>
<td>Spells out step-by-step rent increases (or decreases), generally paid in installments. An example might be a long-term lease that includes a 3% increase each year of the lease term.</td>
</tr>
</tbody>
</table>

**Lease Alternatives**

A lease may also be the beginning point of a future purchase or the follow-on to a sale:

- **Lease with Option to Buy.** This arrangement is a combination of a lease and an option to purchase (“rent to own”). Some or all of the rent paid may go toward the purchase price. Because there is no obligation to buy the property, this is a **unilateral** contract.
• **Lease Purchase.** This agreement is a combination of a lease and a purchase agreement (or sales contract) where the tenant is obligated to complete the purchase. Some or all of the rent paid may go toward the purchase price as well. Title of the property is not transferred until settlement. This is a **bilateral** contract.

• **Sale-and-Leaseback.** In this situation, a company constructs a building that suits its needs, then sells the building to an investor, who becomes the landlord. This allows the tenant company to have more liquid assets to invest in products or other resources.

**Transferring the Right of Occupancy**

A tenant can transfer her right of occupancy to another person either by **assignment** or **sublease**. The landlord’s consent may not be required for an assignment or sublease unless the original lease **expressly states** it is required or the original lease **expressly forbids** assignment or sublease.

**Assignment**

**Assignment** occurs when the original tenant transfers the lease contract to a second tenant, the **assignee**. Assignment transfers a tenant’s **entire interest**, but it does not transfer a tenant’s entire liability under the lease. With an assignment, the assignee and the **assignor** (the original tenant) **share legal responsibility** for paying rent to a landlord.

The assignee has primary liability; the assignor has secondary liability. If the assignee doesn’t pay, the landlord has a right to sue both the assignee and the assignor for the rent.

**Sublease**

A **sublease** occurs when the original tenant transfers the right of possession or other interest in leased property to another person for only part of the lease term. While similar to an assignment, typically, with a sublease, the **sublessee** pays rent to the original lessee, who then pays the lessor. A sublease does not alter the legal relationship between a landlord and the original tenant.

If the subtenant doesn’t pay as agreed, it is still the original tenant who has full legal responsibility for paying the landlord. If the landlord doesn’t get paid, only the original tenant is liable.

**Novation**

Recall that a **novation** occurs when one party to a contract withdraws and a new party is substituted. By arranging a novation instead of an assignment or sublease, the original tenant can escape liability under the lease altogether. A novation replaces the lease between the landlord and the original tenant with a completely new lease between the landlord and the substitute tenant.

Of course, a novation is only possible with the landlord’s consent.
Challenge Activity

Place a check beside each element that is generally required to create a valid, enforceable real estate purchase agreement.

1. Acknowledgement by officer of the court
2. Closing date
3. Consideration
4. Contractual capacity
5. Earnest money deposit
6. Escape clause
7. Financing contingency
8. In writing
9. Lawful and possible objective
10. Liquidated damages instructions
11. Meeting of the minds
12. Minimum services
13. Property description / identification
14. Recording in the public record
15. Signatures of both parties to the transaction
Summary

1. **Purchase agreements** are contracts in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. In some areas, these may be called purchase contracts, sale contracts, earnest money agreements, and other similar terms. The execution of a valid sales contract conveys equitable title to the buyer; actual title is transferred with the deed at closing.

2. Most states require purchase agreements to be in writing and signed by all parties to be enforceable. Such contracts should indicate the parties, the property to be sold, the interest in the property to be conveyed, the terms of the sale, the total purchase price, and critical dates.

3. Most real estate boards offer approved standard sales contracts that licensees can use only to fill in the blanks with specific data. Generally, drafting sales contracts is considered to be the practice of law and can be performed only by an attorney. Even riders and addenda generally must be drafted by an attorney.

4. The **Uniform Electronic Transactions Act (UETA)** provides a legal framework for the use of electronic signatures and records in government or business transactions, making them legally equivalent to paper writings and manually signed signatures.

5. **Earnest money** serves as the buyer's proof of commitment. It is not required for a valid sales agreement, and it is not consideration for the contract. Earnest money typically serves as liquidated damages for the seller if the buyer backs out of the sale.

6. Purchase agreements may include contingencies for financing, inspections, the sale of other homes, etc. An as-is clause does not relieve a licensee of the requirements to disclose material defects about the property.

7. An **option** is a unilateral contract giving one party the right to do something within a designated time period but without the obligation to do so. The consideration for the option is not refundable if the optionee (the prospective purchaser) does not exercise the option. The **right of first refusal** is a type of option giving the optionee the right to have the first opportunity to buy or lease a property if the optionor (the owner) decides to sell or lease it after receiving a bona fide offer from a third party.

8. **Leases** are contracts in which one party (the lessee) pays the property owner (the lessor) rent in exchange for possession of real estate. Thus, a lease is the conveyance of a leasehold estate from the fee owner to a tenant. Since the lease is a contract, however, the **essential elements of a valid contract** are also necessary for a valid lease.

9. Leases are generally categorized by the method of rent payment. **Gross lease:** Tenant pays a fixed rent, while the owner or landlord pays all ownership expenses, such as property taxes, repairs, insurance, and sometimes utilities. **Net lease:** Tenant pays some or all of the expenses associated with the property in addition to rent. **Percentage lease:** Tenant pays a percentage of gross sales on the premises, often in addition to a fixed monthly rental payment. **Index lease:** Amount of the rent is tied to some common index indicator. **Graduated lease:** Includes step-by-step rent increases (or decreases), often paid out in installments. **Ground lease:** A long-term lease of unimproved land on which tenants may construct buildings that meet their needs.
Chapter Quiz

1. Who are the parties to an agreement of sale?
   A. buyer and listing broker
   B. buyer and seller
   C. buyer, seller, and both brokers
   D. seller and listing broker

2. A real estate purchase agreement has been signed by both buyer and seller and reviewed by their attorneys. The transaction close date is two days away. How would such a contract be classified?
   A. bilateral and executed
   B. bilateral and executory
   C. unilateral and executed
   D. unilateral and executory

3. S signs L’s offer to buy her house, creating a contract. They agree to close in 21 days. Under this contract, L has
   A. actual title in the property.
   B. equitable title in the property.
   C. legal title in the property.
   D. no legal interest in the property.

4. D tells L that he would like to buy her house at some point, and he pays her $2,000 for the option to purchase her house for $200,000 anytime in the next year. With this option to purchase, D
   A. can purchase L’s property only if she receives an offer from a third party.
   B. is obligated to purchase the property should L decide to sell.
   C. may opt out of the agreement and get his $2,000 back from L.
   D. must pay L the $2,000 whether or not he buys her property.

5. P, a victim of identity theft, can’t currently qualify for a loan but wants to buy her friend’s condo for $140,000. P could give him $1,000 now, if he promised not to sell to anyone else in the next six months, giving her the opportunity to purchase the property within that time period. This is
   A. a land contract.
   B. a lease purchase agreement.
   C. an option agreement.
   D. a right of preemption.

6. Which statement about an option to purchase is TRUE?
   A. An option is a bilateral contract.
   B. An option is enforceable by the optionee.
   C. Any money paid with an option must be refunded.
   D. An option does not require consideration to be enforceable.

7. Homeowner T gives F the right of preemption to purchase her lake house if she ever decides to sell it. This agreement is an
   A. executed bilateral contract.
   B. executed unilateral contract.
   C. executory bilateral contract.
   D. executory unilateral contract.

8. Which statement about earnest money is TRUE?
   A. It will be given to the seller as compensatory damages if the deal falls through.
   B. It is the required consideration needed to create a valid contract.
   C. It must be a specific percentage of the asking price.
   D. It shows that a buyer is serious about offering to purchase the property.
9. A condition in a purchase contract states the agreement depends on the property passing a home inspection and radon gas test. This is called a
   A. contingency clause.
   B. counteroffer.
   C. tender offer.
   D. time is of the essence clause.

10. Broker A is helping Buyer B negotiate the purchase of C’s home. Who MOST LIKELY created the purchase agreement they are using?
   A. A, the broker
   B. B, the buyer
   C. C, the seller
   D. a local REALTORS® association

11. Y leases her property to W. Y is the ________, and W is the ________.
    A. landlord / lessor.
    B. lessee / lessor.
    C. lessor / lessee.
    D. tenant / landlord.

12. Who are the parties to a lease?
    A. landlord and property manager
    B. tenant and landlord
    C. tenant and property manager
    D. tenant, landlord, and property manager

13. A landlord is sitting down with a new tenant to look over the lease. For the contract to be valid, which of the following would be required?
    A. The landlord must use the sample lease of the local REALTOR® association.
    B. The lease must be in writing.
    C. The tenant must be at least 18 years old.
    D. The tenant must pay a security deposit as consideration.

14. The most typical lease to be used in a residential rental is a
    A. graduated lease.
    B. gross lease.
    C. net lease.
    D. percentage lease.

15. U leases a storefront for her candy business. The rent for the first six months is $500 and is set to increase 3% every month for the next 18 months as business takes off. U has what kind of lease?
    A. graduated lease
    B. ground lease
    C. index lease
    D. percentage lease

16. R is signing a two-year lease to rent an apartment in a new apartment building. Which of these is LEAST LIKELY to be a requirement for the lease to be valid and enforceable?
    A. It must be in writing.
    B. It must not be for an illegal purpose.
    C. It must require a security deposit as consideration.
    D. R must be at least 18 years old.

17. Which situation results in the MOST liability to an original lessee?
    A. assignment
    B. expiration
    C. novation
    D. sublease

18. H leases a duplex for $750 a month, and her landlord pays all of the utilities, as well as the mortgage, property taxes, repairs, and insurance. What type of lease does H have?
    A. general lease
    B. gross lease
    C. land lease
    D. net lease

19. Of these, which type of lease is most typically used for retail space?
    A. gross lease
    B. land lease
    C. net lease
    D. percentage lease
20. A landlord signs a lease with a tenant. After a month, the tenant's employer transfers her to another state. The landlord substitutes the name of the tenant's friend on the lease for the remainder of the term, relieving the original tenant of liability. This is known as

A. assignment.
B. defeasance.
C. novation.
D. sublease.
While no one expects a real estate licensee to be as knowledgeable about financing as a mortgage loan originator, the reality is that financing has a greater impact on the housing market than any other factor. If you understand some of the concepts and challenges related to real estate financing, you can more easily offer assistance and direction through this often frustrating process.

After reading this chapter, you will be able to:

• Discuss entities and forces that influence the mortgage industry.
• Describe the documents used for financing the purchase of real estate and the typical clauses that they include.
• Discuss various characteristics of mortgage loans.
• Identify examples of mortgage fraud and predatory lending.

**Key Terms**

- Acceleration Clause
- Adjustable Rate Mortgage (ARM)
- Alienation
- Amortization
- Balloon Payment
- Beneficiary
- Blanket Mortgage
- Bridge Mortgage
- Conforming Loan
- Deed of Trust
- Defeasance Clause
- Equitable Title
- Equity
- Fixed Rate Loan
- Hypothecation
- Interest
- Land Contract
- Lien Theory State
- Mortgage
- Mortgagee/Mortgagor
- Origination
- Power of Sale Clause
- Prepayment Clause
- Primary Market
- Principal
- Promissory Note
- Purchase Money Mortgage
- Reverse Mortgage
- Secondary Market
- Servicing
- Straight Loan
- Subordination Agreement
- Subprime Loans
- Title Theory State
- Underwriting
- Wraparound Mortgage
The Mortgage Industry

In the United States from the 1900s through the 1930s, buying a home was a much different process than it is today. When banks first started making home mortgage loans, a purchaser would typically have to make a large down payment (as much as 50% of the purchase price) and accept a loan that had a balloon payment due after a very short term (as short as a year or two, but almost never more than five years). This meant that borrowers were forced into a constant cycle of refinancing, with no interest rate security. Several events led to the mortgage industry we have today.

Federal Reserve System

First, the Federal Reserve Act of 1913 created the Federal Reserve System. This act established a federal charter for banks that permitted them to make real estate loans. Although these loans were initially the short-term, high down payment loans just referenced, the Act established the framework for government involvement with mortgage lending. All nationally chartered banks must join the Federal Reserve (the Fed) and purchase stock in one of the 12 District Federal Reserve Banks.

The Board of Governors, called the Federal Reserve Board, is a seven-member committee that controls the Federal Reserve System. The President appoints governors and the Senate confirms them for a term of 14 years. The Board members control the Fed's monetary policy by implementing various policy tools. It also has substantial control over regulations affecting the activities of commercial banks and bank holding companies and the federal regulations dealing with money.

For the casual consumer, there are a number of misconceptions about the functioning of financial markets in general, and the Federal Reserve in particular. For example, many people assume that the interest rate offered on consumer loans is set by the Fed, which is not the case. The Federal Reserve does, however, implement monetary policies that regulate the flow of money and interest rates through its member banks using four tools: Discount rate, open market operations, reserve requirements, and moral suasion (remember D-O-R-M).

Discount Rate

The discount rate is the rate charged by the Federal Reserve when it lends money to member banks. These rates have a direct influence on the percentage rate of interest that banks turn around and charge to their loan customers. The prime rate, which is the short-term interest rate charged to the bank's most creditworthy customers, is strongly influenced by the Federal Reserve discount rate, but it is not set by the Fed. Instead, it is set by individual banks.

Open Market Operations

Open market operations occur when the Fed sells or buys government securities (bonds) as a means of controlling the supply of, and demand for, money. Interest rates are affected by this activity because when the Fed buys and sells securities, it makes more or less money available for banks to lend. The Federal Open Market Committee (FOMC) meets regularly to discuss the present and future state of the economy, including where interest rates should ideally be to accomplish the Fed's long-term objectives of economic growth and stability with minimal inflation.
If the FOMC believes the economy needs stimulation, the Committee may decide to purchase government securities on the open market. This injects more money into the economy, which reduces interest rates. If the economy is seen as over-heated, the FOMC may decide to sell government securities instead. This action removes money from the economy, makes money “tighter,” and causes interest rates to rise. When interest rates rise less money is borrowed, causing the economy to slow down.

**Reserve Requirements**

Reserve requirements are the percentage of deposits commercial banks are required to keep on deposit, either on hand at the bank or in the bank’s own accounts—in other words, money the bank cannot lend to customers. The original purpose of reserve requirements was to help avert financial panic by giving depositors some confidence that their deposits were safe and accessible. Reserve requirements, however, have also become a policy tool.

By raising or lowering reserve requirements, the Fed controls the supply and cost of money as well as the quality of credit. Increasing reserve requirements decreases the amount of money that is available to make loans. When less money is available to make loans, interest rates rise. On the other hand, by decreasing the reserve requirements and making more money available for loans, the Federal Reserve can stimulate a sluggish market by increasing the amount of money in circulation, which causes interest rates to decrease.

**Moral Suasion**

The Fed also implements monetary policy through moral suasion, which is its ability to use persuasive influences on the public and financial markets to perceive credit in a specific way.

**For Example**

The chairperson of the Federal Reserve Board may make a speech stating the Fed is concerned about rising stock prices fueling inflation. Even though the Fed does not intend to actually raise interest rates, the chair’s statement may still produce the desired effect of reduced activity in the public and financial markets.

**The Supply of Money**

Beyond the influence of the Fed, the supply of money available for mortgage lending is very much affected by forces that have traditionally been at work in the marketplace. This relates to the economic concept of supply and demand: Usually, the more there is of something, the less demand there is for it, which usually lowers prices. In the scope of this discussion, more money in the market leads to lower interest rates, while less money in the market leads to higher interest rates, all else being equal.

- Intermediation is the flow of deposits into lending institutions, creating a mortgage money supply. When individuals deposit funds into banks, savings and loan associations, and credit unions the money becomes available for lending purposes. It follows that high levels of intermediation increase the mortgage money supply, and cause interest rates to decrease.
• **Disintermediation** occurs when depositors bypass traditional depository institutions and invest directly in the stock market, mutual funds, artwork, etc. Large-scale disintermediation can reduce the mortgage money supply and cause interest rates to rise.

![Figure 13.1 Intermediation and Disintermediation](image)

**Federal Housing Administration**

In the United States from the 1900s through the 1930s, buying a home was a much different process than it is today. When banks first started making home loans, a purchaser would typically have to make a large down payment (as much as 50% of the purchase price) and accept a loan that had a balloon payment due after a very short term (as short as a year or two, but almost never more than five years). This meant that borrowers were forced into a constant cycle of refinancing, with no interest rate security.

The **Federal Housing Administration** (FHA) was created by the National Housing Act of 1934 with the intent of helping the housing industry recover from the Great Depression. The FHA was not set up to fund loans; instead, the FHA provides mortgage insurance so banks would not have to incur losses for defaults on home loans.

The creation of the FHA allowed banks to commit more of their funds to home mortgage loans, while at the same time improving the quality of those loans by requiring them to conform to FHA standards. Banks that followed FHA guidelines would be reimbursed for the insured amount of any borrower’s default.

In 1965, the Federal Housing Administration became part of the **Department of Housing and Urban Development (HUD)**.

**Primary Market**

The process of making a mortgage loan occurs in the **primary mortgage market** (or simply, primary market). Broadly speaking, the primary market is made up of various entities that create securities. It is in the primary mortgage market that borrowers and lenders come together to negotiate terms and effectuate mortgage transactions. Since loans are originally created here, the functions of the primary mortgage market include the following:

• **Origination** is the process of making or initiating a new loan. Almost all primary mortgage market entities originate loans. Origination involves taking a loan application, pulling a credit report, ordering an appraisal, and assembling all other forms and documents required by the person or company underwriting the loan.

• **Underwriting** is the process of evaluating and deciding whether to make a new loan. This is most often done by the funding source (whoever is supplying the money for the loan). Underwriting involves evaluating credit scores, credit history, appraisals, job history, assets, and other measures of financial strength or weakness in the borrower and the collateral.
• **Servicing** is *the continued maintenance of a loan after it has been made.* This can be done by any entity, with some companies set up solely to perform this function. Servicing involves maintaining direct contact with borrowers, sending mortgage statements, collecting payments, and pursuing late payments. Often primary lenders sell mortgages to the secondary market but still service them for a fee.

**Primary Mortgage Market Participants**

The source of funds for the primary mortgage market is largely made up of the *deposits* of individuals and businesses in the local area served. The lending institution uses those deposits to make real estate loans to members of the same community. The primary mortgage market is a bit more complicated today with interstate lenders, online lenders, and national mortgage companies. However, the traditional primary market still consists of various lending institutions, serving borrowers in local communities:

- **Commercial banks** are *financial institutions that provide a variety of financial services,* including loans. The vast majority of the deposits they hold are *demand deposits*—money that a customer may withdraw from the bank at any time. In recent years, commercial banks have increased their participation in home mortgage lending to take advantage of existing customer relationships built through checking accounts and other traditional services.

- **Savings and loan associations (S&Ls)—sometimes called *thrifts*—are financial institutions that specialize in taking savings deposits and making mortgage loans.** Traditionally, S&Ls were the major real estate lending institutions, able to dominate local mortgage markets mainly because deposits placed with S&Ls were savings deposits less frequently subject to immediate withdrawal than demand deposits. Management mistakes and risky investments resulted in a dramatic increase in the failure rate of S&Ls, which cost the federal government and taxpayers billions of dollars, leading to a massive restructuring of the industry. Despite this crisis, S&Ls continue to participate as home mortgage lenders.

- **Mortgage banking companies,** or mortgage bankers, are *institutions that specialize in only making mortgage loans to consumers.* Unlike other financial institutions, they do not take deposits from customers. Technically, a mortgage banker can be a company, individual, or institution that originates, processes, underwrites, closes/funds, and may service mortgage loans.

- **Insurance companies** are *institutions with large sums of stable, long-term investment capital looking for high-return investments.* Insurance companies typically invest premium funds in *long-term commercial mortgages* and other large *development projects,* such as office buildings and apartment complexes. However, insurance companies also participate in residential mortgage financing, but they tend to do so by purchasing blocks of residential mortgages in the secondary mortgage market versus originating single-family residential loans.

- **Credit unions** are *cooperative financial institutions owned and controlled by their members* in order to pool their deposits, receive better interest rates, and loan money to fellow members.

- **Finance companies** are *organizations that specialize in making higher-risk loans at higher interest rates.* Finance companies are sources of second mortgages and home equity loans made directly to borrowers, and are often in a position to loan higher percentages of the borrower’s equity in the property and will work with borrowers who have blemished credit and then price their loans accordingly.
- **Mutual savings banks** are state-chartered banks that are owned by depositors and operate for their benefit. They are conservative by nature, and often hold a large portion of their assets in home mortgages. While they are found mostly in the northeastern United States, there are a number of savings institutions in other areas that continue to operate as mutuals. Like S&Ls, mutual savings banks are known as *thrifts*.

- **Portfolio lenders** are financial institutions that make real estate loans, then keep and service those loans in-house as part of their investment portfolios, instead of selling them on the secondary market. Major financial institutions, smaller community banks, or some types of nontraditional lenders or investors may practice portfolio lending. Portfolio lenders can make lending decisions based on many factors; for example, they may choose to make these types of loans as a service to customers who may need a loan amount larger than can be sold to the secondary market or as an investment because the lender likes the project, rate of return, or possible future profit sharing in a particular real estate venture.

### Mortgage Brokers and MLOs

A **mortgage broker** is a company or individual who, for a fee, negotiates, processes, or places loans with lenders. Mortgage brokers do not service such loans, nor do they underwrite or fund their loans. Rather, they act as a conduit between the borrower and the lender in residential mortgages. It’s the mortgage broker’s job to help the borrower get the best loan rates and terms available. A mortgage broker and a buyer/borrower enter into a type of agency relationship through a *fee agreement*. Mortgage brokers can also be compensated by the lender.

The U.S. economy experienced a significant recession from 2007-2009, due in part to unethical mortgage lending practices. In response, the U.S. Congress passed the **Housing and Economic Recovery Act of 2008 (HERA)**, a major housing law designed to assist with the recovery and the revitalization of America’s residential housing market.

HERA has multiple purposes: the modernization of the Federal Housing Administration, foreclosure prevention, and the enhancement of consumer protections. **Title V**, the **Secure and Fair Enforcement for Mortgage Licensing Act** or **SAFE Act**, is a key component of HERA. It is designed to enhance consumer protection and reduce fraud by requiring national minimum standards for **mortgage loan originators** (MLOs). A mortgage loan originator is a person who solicits, negotiates, explains, or finalizes the terms of a mortgage loan for residential real estate. MLOs must be employed by or affiliated with a licensed mortgage banker or a registered mortgage broker. The SAFE Act requires all states to implement standardized mortgage loan originator licensing.
Secondary Markets

Broadly speaking, a secondary market is a financial domain in which investors buy and sell securities—such as stocks, bonds, mortgage loans, or servicing rights—that were created in the primary market. The federal government established the earliest secondary markets for residential mortgage loans to attempt to moderate local real estate cycles:

- When the secondary market players buy mortgages from local banks, those local banks have more money to lend to other potential homeowners in their area.
- Local banks can use their surplus funds to purchase real estate loans in other regions of the country. That way, their investments are not solely dependent on how the local real estate market is performing.

The secondary mortgage markets allow primary mortgage market lenders to maximize returns on investment dollars and shift credit risk.

Secondary Mortgage Market Participants

While secondary mortgage markets may be made up of private investors—for example, brokers, high-risk investors, insurance companies, or retirement plan companies—three organizations are responsible for the vast majority of secondary mortgage market activity:

- Federal National Mortgage Association (FNMA or Fannie Mae)
- Government National Mortgage Association (GNMA or Ginnie Mae)
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac)

Fannie Mae and Freddie Mac, both government-sponsored enterprises (GSEs), are entities established by Congress to improve the efficiency of markets and enhance the flow of credit to targeted sectors of the economy, primarily in housing and agriculture. Both have substantially similar charters and regulatory structures, and both are under the conservatorship of the Federal Housing Finance Agency. Ginnie Mae, on the other hand, is a wholly-owned government corporation, not a GSE. Also, unlike Freddie Mac and Fannie Mae, Ginnie Mae does not purchase mortgages from lenders, nor does it buy, sell, or issue securities.

Fannie Mae The Federal National Mortgage Association is the nation’s largest investor in residential mortgages. Fannie Mae was originally chartered as a GSE by Congress in 1938 to provide liquidity and stability to the U.S. housing and mortgage markets, primarily as a place for lenders to sell their loans insured by the FHA and guaranteed by the Department of Veterans Affairs (VA).

Fannie Mae funds its operation by securitization, the act of pooling mortgages, then selling them as mortgage-backed securities, for which they guarantee the timely payment of principal and interest. Lenders, who must own a certain amount of stock in Fannie Mae, assemble a pool of loans and sell a participation interest in that pool (usually 50% to 95%) to Fannie Mae. The originator lender or another mortgage servicing company services these loans, for which Fannie Mae pays a service fee.

Ginnie Mae The Government National Mortgage Association was created in 1968 as a government-owned corporation, operating under the Department of Housing and Urban Development (HUD). Ginnie Mae promotes investment by guaranteeing the payment of principal and interest on federally insured or guaranteed mortgages through
its mortgage-backed securities program. Ginnie Mae works specifically with loans that originate from FHA, VA, Rural Housing Service, or HUD’s Office of Public and Indian Housing. Ginnie Mae’s mortgage-backed securities are the only securities that carry the full faith and credit guarantee of the United States government. Therefore, regardless of whether the mortgage payment is made, investors will receive payments.

**FREDDIE MAC** The **Federal Home Loan Mortgage Corporation** was created in 1970 as a nonprofit, federally chartered institution controlled by the Federal Home Loan Bank System. Like Fannie Mae, Freddie Mac actively sells the mortgage loans from its portfolio to investors throughout the world by issuing its own mortgage-backed securities, thus acting as a conduit for mortgage investments. The funds generated by the sale of the mortgages are then used to purchase more mortgages. While its mortgage-backed securities do not carry the full faith and credit of the federal government, Freddie Mac, like Fannie Mae, has special authority to borrow from the U.S. Treasury to continue operating in the secondary market.

![Figure 13.2 Mortgage Securitization](image)

**Figure 13.2 Mortgage Securitization.** 1. Borrower gives a mortgage to lender; lender gives money to borrower. 2. Lender sells mortgage to secondary market. 3. Secondary market bundles mortgages into pools. 4. Investors buy mortgage-backed securities from secondary market.

**Standardization**

In order for the secondary mortgage market to operate successfully, the criteria used to qualify borrowers and property had to be **standardized**. Standardization creates a reliable baseline for the mortgages that are bought and sold. A mortgage will be purchased by the secondary mortgage market only if the primary market lender conformed to certain underwriting standards. Any changes implemented by secondary mortgage markets become requirements around the country for those wanting to sell mortgages on the secondary market.

While criteria may relax or tighten in response to current economic or market factors, this standardization of loan qualifications and other lending procedures helped reduce or eliminate much of the variation in loan quality and the types of loan programs offered. These underwriting standards also create some degree of confidence in purchasers of the mortgage-backed securities. The purchasers know that the mortgages backing the securities must be of minimum quality, lessening their risk in investing in securities without a minimum threshold of reliability and trust in those securities.
**Conforming versus Nonconforming Loans**

When a loan *meets the criteria necessary to be sold into the secondary market*, it is considered a **conforming loan**. **Nonconforming loans**, on the other hand, do not meet these standards, and therefore **cannot be sold** to Fannie Mae or Freddie Mac. There are two main reasons why a loan would be classified as nonconforming:

- **Size of the Loan.** So-called **jumbo loans** exceed the maximum loan amount for conforming mortgage loans established by Fannie Mae and Freddie Mac. Maximum loan limits are determined by the number of dwelling units in the home (for multifamily properties) and its geographic location.

- **Credit Quality of Borrower.** A borrower who does not meet the minimum qualification standards established by Fannie Mae/Freddie Mac is classified as a **B or C borrower**, i.e., someone who has had a credit problem in the past.

**Contributors to the Mortgage Crisis**

Over the years, changes in the industry, along with rising interest rates and a desire to shift credit risk, caused lenders to place even greater emphasis on the ability to sell their loans on the secondary market. The secondary mortgage market, led by Fannie Mae, grew in importance as both a source of funds for lenders and a means of selling mortgage-backed securities. However, this demand for quick profits through the sale of mortgage-backed securities is considered one of the factors that led to the housing bubble and mortgage crisis that caused such upheaval in the financial world beginning in 2007.

In order to make more and more residential loans, however, lenders created many new loan programs, some of which had **relaxed qualifying standards**, such as no down payment, no income verification, and no appraisal. **Subprime loans** have also been recognized as a contributing factor to the mortgage crisis. These are alternative financing tools intended to help people who may have poor credit history, higher debt, lower income, previous bankruptcy, short employment history, and other less than ideal characteristics to reach their goal of homeownership. Some lenders and investors were willing to make these riskier loans because they could charge much higher rates and fees. For some borrowers, it was the only way to buy a house and re-establish credit. Such loans frequently resulted in a high rate of default and foreclosure.

As the properties securing mortgage loans declined in value, the mortgage-backed securities also declined in value—some to the point of being worthless—and investors quit purchasing them. As result, lenders in the primary mortgage market could not sell to the secondary market, which tightened the availability of credit around the world.

**Instruments of Financing**

Homebuyers need financing, i.e., money, and as a result are willing to mortgage their new home to a lender in order to secure a loan. It is important to understand the different types of finance instruments that are used in these transactions. The term **instrument** refers to *a written legal document that establishes the different rights and duties of the parties involved*. There are two types of real estate finance documents:

- **A financing instrument**, typically a promissory note
- **An accompanying security instrument**, such as a mortgage or deed of trust

The financing instrument and the security instrument are two separate documents that work in conjunction with one another.
Promissory Notes

Promissory notes are financing instruments that evidence a promise to pay a specific amount of money to a specific person within a specific time frame. Simply stated, a promissory note is a written promise to pay money. Before a lender will finance the purchase of a house, the borrower must promise to repay the funds.

The person promising to pay the money is called the maker of the note, usually the borrower. The one to whom payment is promised is called the payee, usually the lender (though it could also be the seller). Promissory notes are basic evidence of debt, showing who owes how much to whom.

Negotiable Instruments and the UCC

Most promissory notes used in real estate are negotiable instruments, meaning that they are freely transferable from one party to another. When a note is freely transferable, the lender or other creditor can obtain immediate cash by selling the note. For example, a lender may sell real estate notes to the secondary market.

The Uniform Commercial Code (UCC) is a comprehensive body of statutory recommendations to govern commercial transactions within the United States and its territories (Puerto Rico, Guam, U.S. Virgin Islands). The UCC addresses contract formation and breach of contracts, as well as provisions related to negotiable instruments.

HOLDER IN DUE COURSE Secondary market investors will buy only promissory notes that are negotiable because they want to be a holder in due course of the notes. A holder in due course is one who acquires a negotiable instrument in good faith and for consideration and has certain rights beyond those of the original payee.

An example of a holder in due course would be an entity such as Fannie Mae purchasing a note from a lender as an investment at a fair price. The provisions of the UCC provide the holder in due course some assurance that there is no irregularity in the note.

The UCC also ensures that a holder in due course will get paid in circumstances where the original payee may not have been paid. For example, if there was fraud in the transaction because the original payee convinced the maker to sign the note by making false statements, a holder in due course could still go after the maker to get paid; whereas, the original payee could not. On the other hand, if there was a forgery or material alteration of the note, neither a holder in due course nor the original payee could force the maker to pay.

Types of Promissory Notes

There are four basic types of promissory notes used in real estate transactions. The differences are based on the way that the repayment of the loan is structured:

- **Straight Note.** Requires payments of interest only during the term of the note with a balloon payment (lump sum) at the end of the loan term to pay off the principal amount (also referred to as a term note).

- **Installment Note.** Requires periodic payments of the principal amount only, with a balloon payment at the end of the loan term to pay off the balance due, as well as interest and fees.
• **Fully Amortized Installment Note.** Requires the regular payment of principal and interest calculated to pay off the entire balance by the end of the loan term. This is the most common type of conventional home loan payment structure in use today.

• **Adjustable Rate Note.** Permits the lender to periodically adjust the interest rate so the rate accurately reflects fluctuations in the cost of money; rate adjustments are tied to the upward and downward movement of a selected index.

### Lien Theory and Title Theory

Some states follow what is called **lien theory**, others follow what is called **title theory**, and some states follow a hybrid of the two, sometimes called **intermediate theory**.

In lien theory states, the security instrument creates a lien against the property that must be repaid by the debtor. The property serves as collateral, or security, for the debt. The borrower still holds legal title to the property and has possession of it. This is a concept known as **hypothecation**. In most lien theory states, the lender would be required to go through a judicial foreclosure proceeding to obtain title in the event of borrower default.

In title theory states, while the debt is outstanding, the lender (or the lender’s trustee) holds legal title to the property. The borrower has possession of the property, but until the debt is fully paid, the borrower has only equitable title. Once the loan amount has been repaid, legal title is conveyed to the owner (borrower). Upon default, the creditor may begin a nonjudicial foreclosure procedures, which allows the property to be sold without court supervision.

### Security Instruments

A security instrument, the second type of real estate finance document, requires a borrower to hypothecate or pledge his property as a condition of a loan. This means that the borrower pledges his property as security, or collateral, for the loan, while still maintaining possession of it. The security instrument protects the lender and serves to motivate the borrower to fulfill the terms of the promissory note and repay the loan as agreed. Once the loan has been repaid, the security instrument is void and the lender no longer has any claim against the borrower or the property. The lender must issue a document—which may be referred to as a satisfaction of lien, a discharge of mortgage, or a mortgage certificate of release—which should be recorded as evidence that the obligation has been discharged.

There are a number of different types of security instruments, including:

- Mortgages
- Deeds of trust (also called trust deeds)
- Land contracts (also called installment sales contracts)

Security instruments are usually recorded in the public record; financing instruments, such as a promissory note, are not.
Mortgages

A mortgage is the conveyance of an interest in real property to a lender as security for the payment of a promissory note. The borrower (the mortgagor) pledges property to the lender (the mortgagee) as collateral for the debt, creating a voluntary lien on the property, but the mortgagor holds legal title to the property. Once the loan is repaid, the promissory note is canceled. Generally speaking, mortgages are the primary security instrument used in lien theory states.

![Figure 13.2 Mortgage Made and Repaid.](image)

For the lender, the main advantages of mortgages in the event of default are the right to accelerate the entire debt, making it due immediately, and the authority of a court to hold a judicial foreclosure proceeding so that the lender may obtain title and possession. The main disadvantages are the time and expense involved with judicial foreclosure. The entire process can take several months, or even years, to complete, and legal fees and court costs can be extensive, which the lender may or may not recover from the sale of the property.

For the borrower, the advantages and disadvantages of a mortgage correspond to those of the lender, but in reverse. The lender’s right of acceleration may mean that a homeowner who misses one or two payments will be faced with the prospect of having to pay off the entire debt to save the home. On the other hand, because of the time required to legally foreclose through the courts, the debtor usually has a significant period of time in which to bring the loan current.

Trust Deeds

Trust deeds, or deeds of trust, are three-party instruments placing into the hands of a disinterested third party a specific financial interest in the title to real property as security for the payment of a note. When using a trust deed as the security instrument, the trustor (borrower) signs a note and a trust deed and gives the trust deed to a third-party trustee. The borrower using a trust deed has possession of and equitable title to the property.
The trustee holds the title for the beneficiary (lender) and the borrower (trustor) but does not have the rights usually associated with ownership, such as possession of the property. Trust deeds are more common in title theory states, although they may also be used in lien theory states.

Once the terms of the loan have been met, the beneficiary releases the debt obligation, and the trustee conveys clear title to the trustor, recording a reconveyance deed.

Upon default, the lender may initiate a nonjudicial foreclosure action, authorized by a power of sale clause, that allows the trustee to sell the property without court supervision. While regulations on trust deeds vary from state to state, in general, this process may be faster, less expensive, and less complex for the lender than the judicial foreclosure required with a mortgage.

**Land Contracts**

A land contract is another security instrument used to finance the purchase of real estate. It is a real estate agreement whereby the buyer makes payments to the seller in exchange for the right to occupy and use the property, but no deed or title is transferred until all or a specified portion of the payments have been made. Land contracts are also called land installment contracts, contracts for deeds, articles of agreement, installment sales contracts, land sales contracts, and other names.

Under a land contract, the seller (called the vendor) actually holds legal title to the property as security, not just a lien. The buyer/debtor (called the vendee) has the right to possess and enjoy the land, as an “owner in fact,” having equitable title, but no legal title and no deed.

Land contracts usually require the vendor to give the vendee a statement, at least once a year or as requested, showing the amount of payments that have been credited to principal and interest, and the balance due under the contract. Land contracts may be structured subject to an existing mortgage or structured to allow the vendee to assume the vendor’s mortgage.

*States that allow land contracts have very strict laws and regulations regarding the creation of these agreements. Real estate licensees should always consult with their broker regarding participation in these transactions.*
ADVANTAGES AND DISADVANTAGES For the vendee, the main advantage is that a land contract is typically easier to qualify for than a bank loan. For the vendor, the advantage of a land contract is the right to hold title as security. The lack of ownership is, conversely, the main disadvantage for a vendee. Even with some equity built up, the vendee may find it difficult to obtain financing for improvements. Also, a land contract provides little or no protection to the vendee in the event that the land contract or other relevant document with terms of the sale is not recorded.

Another disadvantage is a risk that the vendor, who retains legal title, could transfer or encumber the property while it is under contract with the vendee. Therefore, most state laws prohibit the vendor from using the property as collateral for another loan without the vendee’s consent. This protects the vendee’s interest.

Land contracts are a popular form of seller financing in some parts of the country, providing freedom from institutional loan qualifying standards and flexibility of terms. Land contracts are also more popular when mortgage financing is unavailable for financial or other reasons. In a seller’s market, when many buyers are competing for a limited number of available properties, land contracts are rare.

Figure 13.4 Land Contract Made and Repaid.

LAND CONTRACTS UNDER DODD-FRANK Under provisions of the federal Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, anyone who performs activities related to originating a residential mortgage loan is considered a mortgage loan originator who must be licensed or registered to practice. This requirement applies to the use of land contracts. Dodd-Frank does exempt some land contract transactions:

- An owner/seller—whether a natural person or an estate or trust—that only finances one property in a year.
- An owner/seller—whether a natural person, an estate, a trust, or an entity—that provides financing for less than three residential properties in a 12-month period as long as the loan is fully paid after a fixed period with no balloon payment. In these cases, the seller must also make a good faith determination that the buyer has a reasonable ability to repay the loan.

While land contracts may be used in some states, real estate licensees are cautioned to advise clients and customers to consult a knowledgeable attorney if they’re interested in entering into a land contract.
Types of Security Instruments

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Mortgage</th>
<th>Deed of Trust</th>
<th>Land Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides security for debt; house can be sold to pay the note</td>
<td>Provides security for debt; house can be sold to pay the note</td>
<td>Provides security for debt</td>
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</tr>
</tbody>
</table>

On Default

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<th>Purpose</th>
<th>Mortgage</th>
<th>Deed of Trust</th>
<th>Land Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judicial foreclosure; requires court action</td>
<td>Nonjudicial foreclosure; does not require court action</td>
<td>Forfeiture, not foreclosure process</td>
<td></td>
</tr>
</tbody>
</table>

Advantage for Lender

<table>
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<tr>
<th>Purpose</th>
<th>Mortgage</th>
<th>Deed of Trust</th>
<th>Land Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lender can get judgment against other assets</td>
<td>Faster process and less expensive</td>
<td>Seller gets property back and keeps funds paid</td>
<td></td>
</tr>
</tbody>
</table>

Disadvantage for Lender

<table>
<thead>
<tr>
<th>Purpose</th>
<th>Mortgage</th>
<th>Deed of Trust</th>
<th>Land Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judicial foreclosure is a slow and expensive process</td>
<td>Lender cannot get judgment against other assets</td>
<td>Seller does not get entire sales price in a lump sum</td>
<td></td>
</tr>
</tbody>
</table>

Clauses in Financing Instruments

Financing instruments can use various clauses to give certain rights to the lender or borrower. Many of these common clauses may appear in the promissory note or the security instrument, and often they appear in both.

Acceleration Clause

Gives the lender the right to declare the entire loan balance due immediately because of borrower default or for violation of other contract provisions. Most promissory notes, mortgages, trust deeds, and land contracts contain an acceleration clause allowing the lender to accelerate the debt upon default as defined in the contract.

Alienation Clause or Due on Sale Clause

Gives the lender certain stated rights when there is a transfer of ownership. This is designed to limit the debtor's right to transfer the property without permission of the creditor. Upon sale or even a transfer of a significant interest in the property, lenders often have the right to accelerate the debt, change the interest rate, or charge an assumption fee. FHA and VA loans cannot include an alienation clause.

Condemnation Clause

Ensures if a property is condemned or some or all of the property is taken through an eminent domain action or is otherwise destroyed, the lender has the right to take all or part of the proceeds to satisfy the loan because the condemnation reduced the lender's collateral.

Defeasance Clause

States that in the event a stated condition has been fulfilled, the document becomes null and void. With a mortgage, for example, once the borrower has repaid the debt, the mortgage is canceled and the mortgagee has no further claims on the property. At that point, the mortgagee would prepare a satisfaction of mortgage lien document and places it in the public record.

Occupancy Clause

Requires the borrower to occupy the property within a certain period of time (e.g., within 60 days) and continue to occupy it for a certain period of time (e.g., one year). This clause attempts to prevent people from buying investment properties and saying that they are residential properties.

Partial Release, Satisfaction, or Conveyance Clause

Obligates the creditor to release part of the property from the lien and convey title to that part back to the debtor once certain provisions of the note or mortgage have been satisfied. This important clause appears in many blanket mortgages and some construction mortgages so that the developer or builder can sell off completed homes with clear title before having to pay off the entire amount borrowed for an entire development project.

Power of Sale Clause

Allows the trustee to sell trust deed property, without court supervision, when terms of the trust deed are not kept.

Prepayment Clause

Gives lenders the right to charge borrowers a penalty for paying off the loan early or making substantial principal reductions, essentially depriving the lender of further interest income. This type of clause may be seen in a conventional loan, but it is prohibited in FHA or VA loans. A prepayment penalty is generally a certain percentage of the loan balance.

Subordination Agreement

Gives a mortgage recorded at a later date priority over an earlier recorded mortgage. Normally with mortgages, trust deeds, and other real estate contracts, the first to get recorded has lien priority. In some situations, however, the parties may desire that a later recorded instrument has priority over an earlier one. Subordination agreements are made between lienholders.
Loan Repayment

A typical loan is made up of two components:

- **Principal** refers to the base amount of the loan or the amount originally borrowed.
- **Interest** is a charge for the use of money.

A lender will charge a borrower a percentage of the principal as interest for each year the loan is outstanding.

Amortization

Amortization is the reduction of the balance of the loan by paying back on a regular basis some of the principal and interest owed. **Negative amortization** occurs when the payments are not sufficient to cover the accrued interest on the loan. The unpaid interest, then, increases the balance of the loan. Loans may be broadly categorized by how they amortize.

Straight Loans

A straight loan, sometimes called a bullet loan, is actually a non-amortized loan in which the regular payments cover only the interest over the term of the loan. At the end of the term, a lump-sum payment of the principal is required. This is known as a balloon payment. You may also see straight loans referred to as interest-only loans.

Partially Amortized Loans

A partially amortized loan has periodic payments that apply to both interest and principal but do not fully amortize (pay off) the loan by the end of the loan term. Therefore, the final balloon payment is larger than the other payments.

Fully Amortized Loans

Over the term of a fully amortized loan, regular payments are applied first to interest owed and then to the principal amount. Initially, more of the monthly payment goes to the interest payment and less goes to principal reduction. If all payments are made on time, the last scheduled payment will pay the loan off in full. This is also known as a self-liquidating loan. Fully amortized loans may have a fixed rate of interest or an adjustable rate of interest. They may also be structured with graduated payments or as growth equity mortgages.

As the principal amount owed, or loan balance, decreases, the owner's equity in the property increases.

Fixed Rate Loans

**Fixed rate loans** have interest rates that remain constant for the duration of the loan. This is both good and bad for the borrower and the lender. Of course, the biggest advantage is that a borrower doesn't need to worry when interest rates increase. If interest rates decrease enough, the borrower can refinance to a lower rate, paying less over the life of the loan. From the lender's perspective, there's a guaranteed rate of return, but the rate is generally locked in for a long period, such as 30 years.
Adjustable Rate Loans

Adjustable rate mortgages (ARMs) permit the lender to periodically adjust the interest rate to reflect fluctuations in the cost of money. ARMs are popular alternative financing tools when rates are high as they may help borrowers qualify more easily for a home loan or for a more expensive home. Many lenders like ARMs because they pass the risk of fluctuating interest rates on to borrowers: If interest rates climb, payments can go up; but if they decline, payments can go down.

Because ARMs shift the greater risk of interest rate fluctuations to the borrower, lenders normally charge a lower rate for an ARM than for a fixed rate loan. Although the majority of borrowers prefer the security of a fixed rate (provided the rate is not too high), ARMs have maintained a place in the market even in times of comparatively low mortgage rates.

Some ARMs contain a convertibility option that allows the borrower to convert to fixed rate loan. ARMs with a convertibility option usually limit the time period to choose to convert and charge a fee for conversion. Loans offering the option to convert often have a higher interest rate than a straight ARM.

Index and Margin

The borrower’s interest rate is determined initially by the cost of money at the time the loan is made. To determine a current ARM interest rate, the lender designates an index, which is a statistical report that is a generally reliable indicator of the approximate cost of money, and adds to that its margin, which is the lender’s profit. Future rate adjustments for ARM loans are based on fluctuations in the index.

Current Index Value + Margin = Interest Rate

Several acceptable indexes are published periodically that are easily available to lenders and borrowers. Three of the most commonly used indexes for ARM loans are:

• Treasury Constant Maturity Index (TCM), which is an average of the monthly yields of U.S. Treasury securities adjusted to a constant maturity of one year.

• Cost of Funds Index (COFI), which is the monthly weighted-average interest rate paid by the 11th Federal Home Loan Bank (FHLB); district savings institutions for savings, checking, advances from the FHLB; and other sources of funds.

• London InterBank Offering Rate (LIBOR), which is the rate of interest that London banks charge one another.

The lender must give the borrower advance notice of any change in payment, interest rate, index, or loan balance. Such disclosures must be given at least 25 days, but not more than 120 days, before a new payment level takes effect. The lender must also give the borrower an example, based on a $10,000 loan, showing how the payments and loan balance would be affected by changes in the index.
Teaser Rates

Lenders may offer discounted rates to make ARMs more attractive to borrowers. When the initial rate on an ARM, also known as the **start rate**, is less than the fully indexed rate, it is considered a **discounted index rate**, sometimes referred to as a **teaser rate**. The downside to a teaser rate is that it has the potential for a much higher first payment adjustment. Therefore, **interest rate caps** are used with ARMs to limit the number of percentage points an interest rate can be increased during the term of a loan, helping to eliminate large fluctuations in mortgage payments.

Initially, teaser rates were offered without caps, but industry leaders, especially secondary market investors, began demanding caps on ARMs as a means of protecting borrowers from **payment shock** and protecting themselves from **portfolio shock** by having loans that borrowers could no longer pay. Today, lenders cannot base their evaluation of a consumer's ability to repay on teaser rates. Lenders must determine the consumer's ability to repay both the principal and the interest over the long term, NOT just during an introductory period when the rate may be lower.

ARM Caps

An **interest rate cap** in an adjustable rate mortgage determines the greatest change up or down allowed. A common cap might be written as 2/5. The **first** number is the greatest change the interest rate can make either up or down in **any one adjustment period**. The **second** is the lifetime cap, the most the interest rate can go up or down over the **life of the loan**. This is sometimes called the **ceiling**.

For Example

An adjustable rate mortgage has an initial interest rate of 6% adjusted annually. It has an interest rate cap of 1/6. If the standard index used to determine the interest rate increases by 2% in the first year, the interest rate on the loan is capped at 7% (6% + 1%). Over the life of the loan, the interest rate cannot exceed 12% (6% + 6%), regardless of the interest rate indicated by the selected index.

Keep in mind that it works both ways. If interest rates go up, the amount of the increase is capped to protect the borrower, but if interest rates go down, the amount of the decrease is also capped, which protects the lender.

Each lender decides what ratio of loan amount to property value is acceptable. The **negative amortization cap** limits the **growth of the loan balance** beyond that tolerance established by the lender. While negative amortization caps do **not** stop a loan from accruing negative amortization, when the cap is reached, the note usually calls for the lender to adjust or recast the monthly payments to prevent any further negative amortization.
Adjustment Periods

In addition to the index, the margin, and the caps, there are two adjustment periods that must be identified as part of an ARM.

- The rate adjustment period is the interval at which a borrower's interest rate changes. It can range from a few months to many years. The most common rate adjustment periods are every six months or one year. After checking movement in the selected index, lenders notify borrowers, in writing, of any change in the interest rate.

- The mortgage adjustment period, on the other hand, is the interval at which a borrower's mortgage payment changes. Here, the borrower's actual principal and interest payments change. Like the rate adjustment period, the payment adjustment interval can range from a period of months up to many years, and it is possible for mortgage payment adjustments not to coincide with interest rate adjustments.

Hybrid Loans

A hybrid mortgage is a combination of fixed and adjustable rates, meaning that the loan has a fixed rate for a specified number of years, and then the interest rate adjusts regularly for the remainder of the loan term, usually every six months. Hybrid mortgages may be designated by the number of years fixed and adjustable, for example, a 2/28 ARM is a mortgage that has a fixed rate for the first two years, and then the interest rate adjusts every six months for the next 28 years.

Graduated Payment Buydowns

A graduated payment buydown is a plan in which payment subsidies in the early years keep payments low, but payments increase each year until they're sufficient to fully amortize the loan. These may be a borrower's upfront escrow deposit of extra cash that earns interest, or a seller or builder may offer a subsidy to help a buyer keep initial payments affordable.

These loans have a definite structure such that the subsidy for the loan's actual interest rate lasts for only two or three years. Two common types of graduated payment buydown plans are:

- 2-1 buydown is a graduated payment buydown with the payments subsidized for only two years—usually 2% below the interest rate in the first year and 1% the second year.

- 3-2-1 buydown is a graduated payment buydown with the payments subsidized for three years—3% below the interest rate the first year, 2% the second year, and 1% the third year.

Growth Equity Mortgages

The growth equity mortgage (GEM), or rapid equity mortgage, is considered a rapidly amortizing mortgage. This type of mortgage has a fixed interest rate, but principal payments are increased according to an index or schedule. The increase is applied directly to reduce the principal, resulting in the loan being paid off more quickly.

With this type of loan, the total monthly payments increase over time but with a predictable escalation. A growth equity mortgage is recommended for a borrower whose income is expected to increase as the payment amount increases. An advantage to this type of loan is that lenders may offer a lower interest rate, which may enable a borrower to qualify for a larger mortgage loan amount.
Calculating Principal and Interest

The Circle-Math strategy can be used to solve problems involving interest. The **annual interest** is the “part,” so it goes on the top. The **principal** (or loan balance) is the “total,” so it goes on the bottom with the **interest rate**. If you know any two factors in the equation, you can easily find the third:

\[
\text{Principal x Interest Rate} = \text{Annual Interest} \\
\text{Annual Interest} \div \text{Interest Rate} = \text{Principal} \\
\text{Annual Interest} \div \text{Principal} = \text{Interest Rate}
\]

**For Example**

We will walk through an example to see how principal and interest are applied on a loan. Let’s assume this is a fully amortized, fixed rate loan, which means that the payment stays the same over the life of loan term, but the amount applied to interest and principal varies every month.

1. The loan amount is $230,000 and the interest rate is 4.5%. What is the annual interest?
   \[230,000 \times 0.045 = 10,350\]
2. When the borrower makes the first monthly payment, how much will be applied to interest?
   \[10,350 \div 12 \text{ months} = 862.50\]
3. If the borrower’s monthly mortgage payment of principal and interest (P&I) is $1,165.00, how much of that first month’s payment will be applied to principal?
   \[1,165 - 862.50 = 302.50\]
4. After the first month’s payment, what is the balance of the loan?
   \[230,000 - 302.50 = 229,697.50\]

In successive months, the amount applied to principal should be a little more than in the previous month. Conversely, the amount applied to interest should be a little less. You know you’re doing the math correctly if you see this type of relationship.
Challenge Activity

Next, you can walk through these steps again to determine the breakdown of P&I for the next month (and the month after that, and so on).

1. The loan balance is now $229,697.50. What is the annual interest?

2. How much will be applied to interest with the second month’s payment?

3. The monthly P&I payment is fixed at $1,165; how much is applied to principal?

4. After the second month’s payment, what is the balance of the loan?

5. Let’s now look at some different scenarios. A fixed rate mortgage loan has an interest rate of 4.75%. When the borrower makes the next payment, $865 will be applied to interest. What is the current loan balance?

6. The current balance on a loan is $42,000. Of this month’s payment, $297.50 is applied to interest. What is the interest rate on the loan?

Types of Loans

Although mortgages and deeds of trust are primarily security devices used to collateralize real estate loans, the word mortgage is often prefaced with adjectives that describe the function the loan is serving or the nature of the circumstances surrounding its use. For example, a construction mortgage is a mortgage used to finance the building of a house; a blanket mortgage secures a loan with two or more parcels of land as collateral. Some mortgages can be more than one type of loan at the same time. For example, you can have a conventional mortgage loan that is a first mortgage (and thus a senior lien), and this same mortgage can also be an adjustable rate mortgage that is a construction mortgage.

Equity Loans

Equity is the difference between the value of a home and the balance of any loans using the home as collateral. Loans that take advantage of the homeowner’s equity include the following:

- Home Equity Loan. Secured by a mortgage on one’s principal residence. A home equity loan is typically a closed-end loan, which means it provides a fixed amount of money that can be repaid with regular payments over a fixed term. Usually, these financing vehicles attach a junior or subordinate mortgage to the property.
• **Home Equity Line of Credit (HELOC).** Type of **open-end** loan in which a borrower is granted a specific credit limit from which he can draw and pay back principal only as he uses it. HELOCs usually attach a junior or subordinate mortgage to the property as well.

• **Reverse Mortgage.** Allows qualified homeowners age **62 or older** to convert equity in the home into a monthly cash stream or line of credit. The borrower must have a substantial amount of equity in the home to make this option viable. The mortgage is repaid if the home is sold, the borrower does not occupy the home for 12 consecutive months, or the borrower dies. This is also called a reverse annuity mortgage, reverse equity mortgage, or home equity conversion mortgage (HECM).

### Collateral Loans

**Collateral** is *property—real or personal—that serves as security for a loan*. Loans that are designed for different types of collateral include the following:

• **Chattel Mortgage.** A type of mortgage in which **personal property** is used as security for the debt. Chattel mortgages require a bill of sale instead of a purchase agreement to document all lending and financial information. Since cooperatives are considered chattel, they are usually financed with a chattel mortgage under a Uniform Commercial Code filing.

• **Package Mortgage.** Includes **both** real estate property and personal property. Personal property can include lawn mowers, boats, furniture, etc. These items are financed together with **one contract**. This type of mortgage is commonly used to finance furnished condominium units or resort properties.

• **Blanket Mortgage.** Covers **two or more parcels or lots**, usually to finance new subdivision developments. For example, a blanket loan is taken out on 200 lots rather than a separate loan for each lot being developed. Blanket loans usually have a **partial release clause**, allowing the borrower to pay a certain amount of money to release one or more lots with the mortgage (lien) continuing to cover the other lots.

### Special Purpose Loans

Some mortgage loans meet a unique purpose related to the existence of other loans, such as the following:

• **Bridge Mortgage.** Occurs between the termination of one mortgage and the beginning of the next. When the next mortgage is taken out, the bridge mortgage is repaid. Bridge mortgages are designed to be temporary and are used most commonly for construction financing or, less commonly, for someone buying a new home before selling the old one.

• **Wraparound Mortgage.** A **secondary financing** arrangement in which a lender, who is often the seller, leaves the original loan intact and gives the borrower a second, larger loan. The total amount of a wraparound mortgage includes the previous mortgage's unpaid amount plus the additional funds required by the borrower. The borrower makes payments on the larger loan amount to the secondary lender, who continues to make payments on the original loan.
Construction Loans

A construction loan is a temporary loan used to finance the construction of improvements and buildings on land. Generally, an appraiser will value the property for a construction loan by evaluating the building plans and specifications, completing a “subject to” appraisal. When construction is complete, the appraiser verifies that specifications have been met and the original opinion of value is valid; then the loan is replaced by a permanent amortizing loan, called a takeout loan. New construction can take as long as a year to complete; therefore, some contracts may include extended rate locks.

If a borrower has an earlier, separate loan on the land itself, a lender making a construction loan will likely require a subordination agreement on the land loan. This allows the lender for the improvements to be in a first lien position in the event of default, and the loan on the land will be a junior or subordinate loan.

Construction loans can be profitable, but lenders regard them as risky. Thus, not only do they charge high interest rates and loan fees on construction loans, but they also closely supervise the disbursement of funds to ensure that projects are completed. There’s always the danger that a borrower will overspend and exhaust the loan funds before construction is complete. If the borrower doesn’t have money to finish a project, the lender is left with a partially completed project that can’t be sold easily in its existing state—with a very real possibility of foreclosure.

To protect themselves against this problem, lenders use plans for disbursing construction loan proceeds to guard against overspending by the borrower.

Disbursement

A fixed disbursement plan pays a percentage of funds at a set time. A series of predetermined disbursements, called obligatory advances, are paid out at various stages of construction. For example, the loan agreement may state that the lender will release only 10% of the funds when a project is 20% complete, with future draws of 20% each time construction progresses 20% more toward completion. Lenders often hold the final 10% (or more) of the loan proceeds until the lien period has expired to protect against unpaid mechanic’s liens, which could affect the marketability of the property.

If a valid mechanic’s lien is recorded, the construction loan agreement usually allows lenders to pay it from the part of the loan not disbursed.

Two other common types of disbursement plans include:

- **Voucher System.** The contractor or borrower must pay his or her own bills, and then submit the receipts to the lender for reimbursement.

- **Warrant System.** The lender directly pays bills presented by the various suppliers and laborers on a project.

Seller Financing

Sometimes the only way sellers can make a deal is to finance all or part of the purchase price for the buyer. Of course, to consider this, the seller must not need all the cash immediately from the sale. The seller is taking a risk, but this may enable the property to be sold or sold at a higher price. A seller can charge below-market interest rates or offer financing to a buyer considered a credit risk by other lenders since a seller isn’t bound by secondary market qualifying standards.
When the seller finances all or part of the sale of property for the buyer, the seller retains a mortgage as security, and title passes to the buyer. When the seller finances the purchase, the instruments that the buyer gives to the seller as consideration at settlement may be referred to as a purchase money mortgage (PMM). When a seller takes part of the purchase price as a mortgage to help the sale, it may also be known as a soft money loan, because the borrower receives credit toward the purchase instead of actual cash.

**Loan Assumption**

A loan assumption, on the other hand, occurs when a buyer agrees to take over payments of a seller’s debt on an existing mortgage with the terms of the note staying unchanged. Remember that the mortgage is attached to the property; the property is still security for the loan, but the buyer becomes primarily liable for repayment. The seller remains secondarily liable unless she gets a release from the lender. This type of financing is popular when interest rates are high since a seller may be able to offer the buyer a lower interest rate than the current market rate.

If there is an alienation clause in the note, a loan assumption is not possible unless the lender approves the transaction. Even without an alienation clause, lenders try to protect their interests by approving a new buyer. When considering an assumption, there are three possibilities:

- The lender will accept the assumption and leave the loan terms intact.
- The lender will accept the assumption but will charge an assumption fee and/or increase the loan’s interest rate.
- The lender will not allow the assumption and exercise the alienation clause by demanding full payment of the loan if the transfer takes place.

**“Subject To” Financing**

Similar to an assumption is “subject to” financing. With this,

- A buyer gets a loan to purchase property subject to the seller’s existing financing.
- The buyer acknowledges the seller’s existing financing but accepts no personal liability.
- The seller remains liable for the existing financing.

**Mortgage Fraud**

Fraud is an intentional or negligent misrepresentation or concealment of material facts. Failing to disclose information you’re required to disclose can be a form of fraud. Fraud also includes actively concealing information and making false or misleading statements. Mortgage fraud involves any misrepresentation or concealment used in an attempt to obtain a mortgage loan. It can generally be divided into two main categories:

- Fraud for profit, which is usually perpetrated by industry insiders.
- Fraud for property, which is usually perpetrated by borrowers.

**Mortgage Fraud Participants**

Since many people are involved in the process of making loans for property, the opportunity for fraud exists on several levels. A fraud scheme could be simply the initiative of a desperate borrower, or it could involve the participation of multiple industry insiders.
**Borrowers**

Borrowers who knowingly supply false documents—such as pay stubs, or bank statements—or false information on the loan application commit mortgage fraud regardless of whether they're working in partnership with anyone else. Borrowers who commit fraud typically do so to **obtain ownership** of property. The purpose of the fraud is to make the mortgage loan happen at desirable terms for the borrower.

A borrower might also act as a **straw buyer**, which is someone who allows his name and personal details to be used to obtain a mortgage loan for a property he has no intention of inhabiting. Sometimes straw buyers are paid for their participation in the scheme, and sometimes a straw buyer has no idea that his personal information is being used.

**Lenders and Mortgage Brokers**

Lenders and mortgage brokers commit mortgage fraud by falsifying loan documents, making loans to straw buyers, illegally flipping properties, and perpetrating other schemes. Lenders benefit by making loans that should probably never have been made and selling them to the secondary market as quickly as possible. Mortgage brokers benefit by collecting fees for putting together fraudulent mortgage packages. Dishonest lenders and mortgage brokers see the opportunity to make a loan resulting in a commission with high profitability. Often, these loans are knowingly made to unqualified buyers and eventually result in foreclosure.

**Appraisers**

Appraisals are a critical aspect of mortgage lending. An appraisal with inaccurate information—especially if because of fraud or negligence—can have a serious impact. An **inflated appraisal** scheme occurs when a property is intentionally appraised with a higher-than-market value by an appraiser acting in collusion with a real estate agent, mortgage broker, or lender. Parties to the loan may try to coerce an appraiser to “hit the number,” “push the value,” or “work with us on the number” regardless of the property's relationship to actual market value. If the mortgage is part of sales transactions, continued inflation of values in the same neighborhood (with inflated sale prices) can result in continued appraisals at higher-than-market values that appear justified. Even unsuspecting appraisers may be caught in this scheme if they unknowingly use the inflated sale prices as comparables.

**Real Estate Licensees**

Real estate licensees are not immune to mortgage fraud schemes. They may assist in the preparation of false documentation, such as purchase agreements or property inspections, or find straw buyers for the property. Real estate licensees may collude in flipping schemes by finding borrowers for scams and by raising listing prices of homes after a deal is put together to make the overinflated appraisal value appear valid. Unscrupulous real estate licensees may also steer borrowers to specific lenders or settlement service providers in exchange for an illegal kickback or other consideration.
Other Industry Insiders

The following examples show how other industry insiders can participate in mortgage fraud:

- **Attorneys** may prepare false deeds and get them duly recorded in public records with the participation of government workers.
- **Accountants** may falsify tax returns, profit and loss statements, and other documentation required by lenders to qualify loans.
- **Title companies** may charge a borrower fees for services never provided at the closing or may provide incorrect title reports that omit valid liens or that create false chains of title.
- **Government workers** may falsify deeds and other records.
- **Rehabbers** and **FSBO (For Sale By Owner) flippers** may use sub-par material, remove materials or fixtures after an appraisal, provide straw buyers, and improperly influence appraisers, loan officers, and title companies.

Property Flipping

One of the most common and well-known mortgage fraud schemes is **property flipping**. Many people are confused by the term “flipping,” as it has long been understood to mean that an investor has remodeled a property and quickly sold it for a profit. If the investor bought the property below market value, and remodeling has brought it up to true market value, this is the good side of flipping and is completely legal. It also serves the public well, as it increases property values, improves neighborhoods, and provides housing that otherwise might not be available.

**Illegal flipping** is something else entirely. Illegal property flipping generally requires collusion between the seller, buyer, appraiser, and lender/broker. An illegal property flipping scheme occurs when a property is purchased at a low price, appraised at an inflated value without any valid reason for the increase, and then resold at a much higher price. It may involve a series of sales and quick re-sales, with one property and a group of sellers and buyers changing ownership among them.

The home in a flipping scheme is typically resold at a new, higher price fairly soon after its initial purchase at the lower price. Statistics show that the criminals involved in these schemes do not wait long time periods, often only weeks, or perhaps a few months at most.

Typically, flipping schemes are more prevalent in mixed value areas where higher-priced homes are located near lower-priced homes in poor repair, and home values fluctuate extremely. Homes involved in flipping schemes are often purchased at low prices because they are in poor condition. If repairs are made after the purchase, they are generally cosmetic or exterior-only repairs.
Predatory Lending

Predatory lending involves loans that take advantage of ill-informed consumers through excessively high fees, misrepresented loan terms, frequent refinancing that does not benefit the borrower, and other prohibited acts. The motive for predatory lending is profit. The goal of a predatory lender is to take the property or strip its equity, or to profit from the exorbitant fees charged. While subprime loans are often associated with predatory lending, it’s important to note that not all subprime lenders are predatory. Subprime loans can be a legitimate option for borrowers who face financing challenges, but unscrupulous lenders can take advantage by charging them exorbitant “junk” fees. Predatory lending targets borrowers with little knowledge of, or defense against, these other practices as well:

- **Prepayment Penalties.** Some lenders charge unreasonable fees for prepayment to lock the borrower into the loan and discourage payoff of a highly profitable loan.
- **Extreme Lending.** Predatory loans are often approved without regard for the borrower’s ability to repay. Extreme lending can involve encouraging borrowers to put 50% or more of their income toward their mortgage payment, where any change in a borrower’s financial circumstances creates a greater risk of default.
- **Loan Flipping.** Loan flipping involves refinancing over and over again, usually with no benefit to the borrower in terms of lowering the interest rate or saving fees. The borrower is promised benefits that never materialize. Since the lender profits every time a loan is made, there is no incentive for the lender to recommend otherwise.
- **Changing Loan Terms at Closing.** Changing loan terms at closing is one of the most common predatory lending schemes. Borrowers discover closing documents do not reflect the loan terms and fees originally stated in the good faith estimate. Borrowers must also be cautious not to sign any documents with blanks, as they may find later the blanks are filled in with new loan terms.
- **Bundling.** Lenders may bundle unrelated insurance products—such as life insurance, credit insurance or unnecessary flood insurance—into the mortgage loan to further their profit.
Summary

1. **Monetary policy** is the government’s way to control the supply and cost of money. The Federal Reserve Board (the Fed) is responsible for setting monetary policy, maintaining economic stability, and regulating commercial banks. The Fed’s policy tools are (D-O-R-M): Discount rate (interest rate charged to member banks on overnight loans), open market operation (Fed sells/buys bonds to adjust money supply and demand), reserve requirement (banks must keep money on deposit—can’t lend), and moral suasion (using persuasive influences on public and financial markets).

2. The **primary market** consists of *lenders making mortgage loans directly to borrowers*. Primary lenders include commercial banks, savings and loans, and mortgage companies. *Mortgage bankers* originate loans, usually fund loans with a company’s own funds, and may sell or service those loans. *Mortgage brokers* place loans with investors, usually don’t service loans, and don’t fund their loans, but have access to different lenders and loan programs.

3. The **secondary market** consists of *private investors and government agencies that buy and sell home mortgages*. This was established to moderate local real estate cycles. By selling their mortgages to the secondary market, lenders have money to lend to others. Standardized loan criteria leads to better-quality loans. *Fannie Mae* is the largest investor in residential mortgages, buying and selling securities backed by its pool of mortgages. *Ginnie Mae* is government-owned and managed by HUD. Ginnie Mae guarantees payment of principal and interest on FHA and VA loans for its mortgage-backed securities. *Freddie Mac* issues mortgage-backed securities. Freddie Mac and Fannie Mae are under the conservatorship of the Federal Housing Finance Agency (FHFA). *Conforming loans* meet Fannie Mae/Freddie Mac criteria so they can be sold on the secondary market; *nonconforming loans* (e.g., jumbo loans) do not meet the criteria so they cannot.

4. **Finance instruments** are written documents establishing rights and duties of the parties involved in a transaction. *Promissory notes* are written promises to pay money. They’re negotiable instruments and freely transferable from one party to another if they contain all the elements required by the UCC. A *holder in due course* is one who acquires a negotiable instrument in good faith and will get paid in instances where an original payee may not. The two note types are *straight* and *amortized*.

5. **Security instruments** give creditors the right to sell collateral to satisfy the debt if the debtor doesn’t pay as agreed. A security instrument gives a debtor the right to *hypothecate* (pledge) property as collateral without giving up possession. *Mortgages* are instruments that create a lien against property as security for payment of a note. In case of *default*, judicial foreclosure is the remedy. *Trust deeds* are instruments held by a third party as security for payment of a note. Upon default, a nonjudicial foreclosure can take place by a power of sale clause. *Land contracts* are real estate installment agreements where the buyer makes payments to the seller for the right to occupy and use the land, but the seller holds title until all, or most of, the payments are made.
6. Many clauses are common in real estate contracts. An **acceleration clause** lets the lender call the loan balance due if in default. A **prepayment clause** lets the lender charge a penalty for paying off a loan early. An **alienation clause** gives the lender some stated rights if property is transferred (also called due on sale clause). A **defeasance clause** is used to defeat or cancel a certain right upon the happening of a specific event. A **subordination clause** allows a later recorded mortgage to take priority over an earlier one. A **partial release clause** provides for a lien to be released from part of land if some part of the balance is paid.

7. The word “mortgage” can be prefaced by different words describing its type or function. A **bridge mortgage** is a temporary mortgage between two mortgages, repaid with a later mortgage. A **package mortgage** includes personal property. A **blanket mortgage** is for more than one land parcel. A **construction mortgage** is a temporary loan to finance buildings.

8. **Adjustable rate mortgages (ARMs)** let lenders adjust interest rates. The lender picks an **index** (statistical report reflecting the cost of money) and adds a **margin** (profit margin), which results in the **rate** paid on the loan. ARMs usually start at a low (teaser) rate. The rate or payment can be **capped**. **Negative amortization** occurs when the balance grows if payments do not keep up with the rate change.

9. **Assumption** means one party (buyer) takes over primary liability for the loan of another party (seller). When trying to assume a loan: 1. Lender can accept assumption and leave terms intact, 2. Lender can accept assumption and charge fee or increase interest rate, or 3. Lender will **not** allow assumption and call the note. Prepayment penalties can be charged for paying a loan early.
Chapter Quiz

1. To sell loans to Fannie Mae, the primary market lender must
   A. allow the secondary agencies to audit its books.
   B. be a federal government-affiliated lender.
   C. be willing to suffer significant discounting losses.
   D. follow the underwriting guidelines of the secondary market agencies.

2. Mortgage bankers typically make loans in the
   A. money market.
   B. primary market.
   C. secondary market.
   D. stock market.

3. Mortgage brokers
   A. act as intermediaries between borrowers and lenders.
   B. originate and service mortgage loans.
   C. provide funding for mortgage loans.
   D. underwrite mortgage loans.

4. A primary responsibility of the Federal Reserve is to
   A. determine levels of taxation.
   B. manage the supply of money.
   C. regulate real estate markets.
   D. set consumer interest rates.

5. Which is NOT a function of the secondary markets?
   A. moderate effects of local real estate cycles
   B. provide lenders with money to make more loans
   C. serve as a depository for consumer assets
   D. standardize underwriting guidelines

6. An example of a servicing activity for which a servicing fee may be charged is
   A. collecting monthly mortgage payments.
   B. increasing interest rates charged to borrowers.
   C. purchasing mortgages on the secondary market.
   D. setting reserve requirements and discount rates.

7. Which of these is NOT an example of a security instrument?
   A. deed of trust
   B. land contract
   C. mortgage
   D. promissory note

8. B is ready to cash in her retirement savings and move south. She wants to sell her house to her son and daughter-in-law, who are unlikely to be approved for a new loan. She decides to let them assume her mortgage. If her current mortgage includes a(n) ______________ clause, B may be required to pay the balance in full when she transfers title to the kids.
   A. acceleration clause
   B. alienation clause
   C. power of sale clause
   D. subordination clause

9. Hypothecation involves the
   A. diminishing of the loan balance as monthly payments of principal and interest are made.
   B. passing of legal title to a disinterested third party until a loan is repaid.
   C. pledge of property as collateral for a loan while continuing to possess it.
   D. promise to discharge the lien on the property once a loan is repaid.

10. If a borrower wants to pay more toward principal every month to reduce the total amount of interest he pays, what mortgage clause should he be most concerned about?
    A. acceleration clause
    B. alienation clause
    C. prepayment clause
    D. subordination clause
11. A loan in which the total payments over the life of the loan pay off the entire balance of principal and interest due at the end of the term is referred to as
   A. annualized.
   B. compounding.
   C. diminishing.
   D. fully amortized.

12. V gets a 10-year straight loan for $60,000 at an interest rate of 4% to finance the purchase of a vacation cottage in the hills. Every month, she pays the lender $200. In 10 years, how much will she owe the lender?
   A. $0
   B. $24,000
   C. $60,000
   D. $84,000

13. L has a 20-year fixed rate loan for $146,000 at an interest rate of 5%. Her monthly payment of P&I is $963.54. What is the principal reduction with the first monthly payment?
   A. $355.21
   B. $481.17
   C. $528.03
   D. $608.33

14. M took out a 30-year fixed rate loan for $165,000. At 4.75% interest, his monthly payment of principal and interest is $860.72. What is the balance of his loan after making his second payment?
   A. $164,139.28
   B. $164,346.87
   C. $164,583.99
   D. $164,792.41

15. B has a 30-year, fixed rate, fully amortized mortgage loan for $110,000. He pays $695.20 for principal and interest every month. How much interest will he pay over the life of this loan?
   A. $20,856
   B. $110,000
   C. $140,272
   D. $250,272

16. With an adjustable rate mortgage, the index is added to the ______ to determine the ______.
   A. cap / margin
   B. interest rate / principal
   C. margin / interest rate
   D. principal / cap

17. What type of mortgage could provide the borrower with a monthly check instead of the borrower making a monthly payment?
   A. blanket mortgage.
   B. graduated payment mortgage.
   C. interest only mortgage.
   D. reverse mortgage.

18. A mortgage that includes more than one parcel of land is called a
   A. blanket mortgage.
   B. package mortgage.
   C. purchase money mortgage.
   D. wraparound mortgage.

19. At closing, buyer S sees that the lender changed the terms of the loan that they had agreed to, but he felt he had no choice but to go ahead with the loan or lose the chance to buy the house. This could be an example of
   A. creative financing.
   B. loan flipping.
   C. predatory lending.
   D. subprime financing.

20. Which situation does NOT involve a straw buyer?
   A. A revises his payroll documentation so he can qualify for a loan to buy his dream house.
   B. B uses his twin brother’s Social Security number and credit information to apply for a loan.
   C. C agrees to secure a loan under his name, though only his sister with bad credit will live in the house.
   D. D tells E, who is facing foreclosure, that if he deeds the property to her, she will refinance it as her primary residence, but he can live there as the sole occupant.
Financing Practice

Now that you are familiar with financing principals, we’ll look at real estate financing from a more practical perspective. In this chapter, we will examine the loan process and take a brief look at some mortgage related laws and various government-backed mortgage programs. Finally, we will discuss what happens in the unfortunate event that a borrower is unable to repay the loan.

After reading this chapter, you will be able to:

• Describe the basic steps in the loan process.
• Recall relevant provisions of federal mortgage-related laws.
• Apply factors used for borrower qualification.
• Contrast various loan programs, including government agency loan programs.
• Compare judicial and nonjudicial foreclosure and discuss alternatives to foreclosure.

Key Terms

Annual Percentage Rate (APR)
Conventional Loan
Debt-to-Income Ratio
Discount Point
Entitlement
Equitable Right of Redemption
Escrow Account
FHA-Insured Loan
Foreclosure
Housing Expense Ratio
Judicial Foreclosure
Loan Estimate
Loan-to-Value Ratio (LTV)
Mortgage Insurance Premium (MIP)
Nonjudicial Foreclosure
Origination Fee
PITI
Point
Private Mortgage Insurance (PMI)
Real Estate Settlement Procedures Act (RESPA)
Secondary Financing
Short Sale
Statutory Right of Redemption
TRID Rule
Truth in Lending Act (TILA)
Usury
VA-Guaranteed Loan
The Loan Process

From the homebuyer's perspective, a mortgage loan is the means to finance a purchase of real estate. For first-time homebuyers, however, the loan process can be daunting. Unfortunately, many homebuyers are unprepared. They might not realize the costs associated with getting a loan. They might not have a clue how much they can really afford to spend on housing every month. Your understanding of the basic steps, requirements, and expectations can help your buyer clients and customers move through this phase of the transaction more smoothly. And just as there's a language associated with real estate, you’ll find that mortgage lending has its own language that you need to learn to speak as well.

Prequalification versus Preapproval

Generally speaking, with today's federal disclosure requirements, borrowers should complete a loan application only when they are ready to buy a particular home. Even if the borrower is not ready to make an offer on the house, the borrower may be prequalified. This is not the same as being preapproved. The two terms are not interchangeable.

Prequalification

Prequalification is the informal process of determining how much a potential homebuyer might be eligible to borrow. While this may be done by a lender or a mortgage broker, it does not guarantee approval. Prequalification of a borrower is not binding on the lender, which is why the distinction is important. A real estate licensee might say he's “prequalifying” a buyer client, analyzing income and debt to get an idea of how much house the prospective buyer may be able to afford. However, this should NEVER be confused with the lender's preapproval process, as a licensee's analysis will have no relevance to a lender or a seller.

Preapproval

Preapproval is the process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money. The lender is rendering a credit decision. A real estate licensee or mortgage broker cannot give a borrower a pre-approval; only the lender can preapprove. To obtain a preapproval, a borrower must complete a loan application and provide documentation of income, assets, debts, etc. By granting a preapproval, a lender states that the prospective borrower's situation has been investigated and, provided all circumstances stay the same, the lender is willing to loan a certain amount of money to purchase a specific property. Preapprovals are always in writing and always follow the policies and procedures established by the mortgage lender.

A borrower may be able to get conditional preapproval before a signed purchase agreement is in place. This is especially helpful when working with buyers because it is a powerful negotiation tool. Sellers are generally more inclined to accept an offer from a preapproved buyer and might even require preapproval. Of course, a borrower's circumstances can and do change, which is why there are always conditions on a preapproval.
Interest Rates

One topic that inevitably arises very early in a borrower’s conversations with a mortgage loan originator is the interest rate that may be available. When considering interest rates, lenders may use the term basis point, which is 1/100th of a percentage point. For example, 325 basis points equal 3.25%, which can also be written as 3 1/4%, or 0.0325. Other interest-related terms include:

- Rate Lock. This is a commitment guaranteed by a lender that an interest rate will not change on a specific loan for a specific period of time. Since a lock-in agreement generally requires that the loan close by a specific date, the anticipated close date should be carefully considered. If a loan closes after the rate lock expires, the lender has the option to offer the current market rate or the original lock-in rate.

- Float. Between the time of application and closing, a borrower may choose to bet on interest rates decreasing by electing to float. Floating is essentially choosing not to lock the interest rate. Since it is the borrower’s responsibility to lock his rate before closing, choosing to float could be risky during times of increasing inflation as it could result in a higher interest rate.

Usury laws are state laws enacted to protect individual borrowers from being charged excessive interest rates by lenders.

Common Fees

There are likely to be fees involved when applying for a loan, for example, fees for pulling a credit report or securing an appraisal. Fees that occur only when a loan closes are likely to be paid out of closing funds, but other early expenses must be paid, even if the loan doesn’t close.

Of course, there are also fees for the privilege of borrowing money. For loans that actually close, lenders charge a loan origination fee to cover the administrative costs of making and processing the loan, including setting up the loan on the lender’s books. Such fees may be referred to collectively as points. A point is simply 1% of the loan amount.

For Example

On a $120,000 loan, the borrower would have to pay an additional $1,200 for every point the lender charged as an origination fee: $120,000 x 0.01 = $1,200

If the lender charged 1 1/2 points for the loan, therefore, the borrower owes $1,800: $1,200 x 1.5 = $1,800

Another way to calculate that would be: $120,000 x 0.015 = $1,800

Points can be charged for many reasons, such as closing fees, underwriting fees, documentation fees, etc. All origination fees must be disclosed to the borrower.

MLOs can collect a credit report fee at application, but none others until the required disclosures are delivered to the borrower and the borrower indicates her intention to proceed with the transaction. At that point, other transaction fees—such as for an appraisal—may be charged.
Discount Points

Discount points are points (1% of the loan amount) the borrower chooses to pay at the beginning of a loan to reduce the note interest rate charged. This allows a borrower to pre-pay some of the interest in return for lower monthly payments. Generally, each point brings the interest rate down 1/8 of a percent, which could allow the borrower to qualify for a loan that might not otherwise be possible. Who pays the points is open to negotiation; a seller or builder may be willing to pay discount points to make the property more marketable. Discounts points may be permanent or temporary.

For Example

A lender offers D a 30-year fixed rate loan of $150,000 at 4.75% interest. Assuming no other bank fees, at an interest rate of 4.75%, she will owe the lender about $782 every month for 360 months to cover the principal and interest due on the loan.

She can pay 2 points, or $3,000 ($150,000 x 0.02), at closing to bring the interest rate down to 4.5%. The lender is effectively earning 4.75% over the life of the loan, although the borrower’s payment is based on an interest rate of 4.5%, making it about $760 every month. Every month, D is paying $22 less than she would have had she not paid for 2 discount points up front.

The longer D stays in the property, the more likely she is to recover that upfront investment. At $22 a month, it would take her 136.36 months to recover the $3,000 ($3,000 ÷ $22 per month) she paid. This is about 11 years and 4 months (136.36 ÷ 12 months = 11.36). The lender would be very happy if D sold the house and paid off the loan more quickly because it would increase the lender’s yield.

Don’t be confused by the term “discount.” It’s important to note that the borrower is not actually getting a discount. Over the full term of the loan, the borrower will owe essentially the same amount. It merely means that the interest rate is discounted.

Yield Spread Premium (YSP)

Yield spread premium (YSP) is a tool that lenders can use to lower the upfront closing costs for a borrower. YSP allows a borrower to accept an interest rate that is slightly higher in exchange for lowering or eliminating fees and closing costs.

Annual Percentage Rate

Lenders are required to disclose the annual percentage rate (APR) so that borrowers have the information necessary to make informed comparisons among lenders. The APR is a combination of the interest rate, loan fees, discount points, and all other charges for obtaining the loan calculated on an annual basis. The APR is sometimes called the effective rate of interest and is not the same as the nominal rate of interest. The nominal rate of interest is the interest rate stated on the promissory note.

Considering the nominal interest rate alone may be misleading or confusing to the borrower. Lender A may charge 5% interest, for example, while Lender B charges 4.75% interest. However, there may be other total finance charges to consider. Lender A may charge 1 point as a loan origination fee, while Lender B charges 1 1/2 points, for example. Or one may offer the borrower the option of paying discount points, while the other does not offer that option.
**Property Insurance**

Lenders who provide funds to purchase homes carry a great deal of financial risk. They have what is known as an **insurable interest** in the property. To protect that collateral, therefore, lenders normally require **homeowners hazard insurance**. This is a policy that covers loss or damage to the home or property in the event of a fire or another disaster such as tornado, snow, or hail. Lenders generally:

- Require the policy to be sufficient to replace the home or reimburse the mortgage amount with the lender being named on the actual policy.
- Have the right to place insurance on the property to cover its interest (the loan value) in the event of a loss if the customer does not comply with the lender's insurance requirements.
- Require buyers to pay the first year’s insurance premium in full prior to closing.
- Incorporate the annual insurance cost (along with current property taxes) into an **escrow account**.

**Flood Insurance**

Homeowner’s hazard insurance does **not** cover damage caused by the peril of flood. When a property is located in a federally designated special flood hazard area (SFHA), the lender for federal loans will require a flood insurance policy for the life of the loan in addition to hazard insurance. Flood insurance must be purchased from the **National Flood Insurance Program (NFIP)** or from another participating insurer.

**C.L.U.E.® Report**

**Comprehensive Loss Underwriting Exchange** (C.L.U.E.)® is a national database maintained by Lexis/Nexis® that tracks insurance claim history on real property and automobiles. C.L.U.E.® reports are typically ordered by a potential new insurer to evaluate the number of and types of property loss claims filed by the insured in the past five years. The report may also include inquiries made by the insured, even if a claim was never filed. Information in the C.L.U.E.® report is often used to determine rates when underwriting an insurance policy. The claims history also reveals a snapshot of any issues with the property, such as fire, water, mold, or storm damage, and it provides some supporting evidence of the property disclosure form. Only by lenders, insurers, and property owners may order a C.L.U.E.® report.

> Most listing agents ask sellers to obtain a C.L.U.E.® Home Seller’s Disclosure Report when listing the property. The report would then be available for prospective buyers.

**Escrow Accounts**

Lenders generally require borrowers to establish an **escrow account**—sometimes called an **impound account** or **reserve account**—into which the borrower makes periodic payments to cover the **property taxes** and **property insurance** that is owed. In lieu of an escrow account, a borrower may pledge an interest-bearing deposit with the lender in an amount sufficient to secure the payment of anticipated taxes and insurance.
The necessary amount, which is prorated over the next 12 months, is added to the monthly principal and interest due for loan repayment. Upon payment each month, the insurance and taxes are deposited into the client’s escrow account. When property taxes and insurance become due, the lender/servicer forwards the payment to the respective recipients on behalf of the property owner. This process protects the lender’s interest in the property by ensuring these important payments are made.

When all of these expenses are bundled into a single mortgage payment, it is called a budget mortgage.

**PITI**

PITI is an acronym for a typical mortgage payment that is the sum of monthly

- Principal
- Interest
- Taxes (ad valorem property taxes and perhaps mandatory special assessments, if applicable)
- Insurance (homeowners hazard insurance and mortgage insurance, if applicable)

When the collateral property requires homeowners association fees as a condition of ownership, such as for a condominium, that monthly amount must also be added to PITI to get the complete housing expense.

**For Example:**

A borrower is getting a $200,000, fixed rate, 30-year loan at 5% interest to purchase a condominium. The monthly payment of principal and interest is $1,073. Property taxes for this property are $3,900 per year. An annual homeowners policy is $864. The monthly condo association fee is $180. What is the borrower’s monthly PITI payment?

\[
\begin{align*}
\text{P&I} & = 1,073.00 \\
\text{Monthly Property Tax} & = 325.00 \\
\text{Monthly Homeowner’s Insurance} & = 72.00 \\
\text{Monthly Condo Association Fees} & = 180.00 \\
\text{Total Monthly Mortgage Payment} & = 1,650.00
\end{align*}
\]

The monthly PITI payment for this loan is $1,650. This is the number the underwriter uses when applying the loan qualifying ratios.
Loan Application

Lenders expect the loans they make to be repaid in a timely manner without collection or foreclosure. Thus, Fannie Mae and Freddie Mac’s Uniform Residential Loan Application is designed to elicit responses that detail the borrower’s financial history, trends, and attitude as a means of trying to predict future loan repayment behavior. The loan application includes:

- **Property** information and purpose of the loan (A principal residence is less risky than a second home.)
- **Personal** information, such as name, address, phone, Social Security number, age, schooling, marital status, number of dependents
- **Employment** information, including number of years on the job, line of work, whether self-employed (Lenders generally look for two years of employment history.)
- **Monthly income** and combined **housing expense** information (current and proposed)
- **Assets**, which are items of value owned by the borrower, such as cash on hand, checking or savings accounts, stocks, bonds, insurance policies, real estate, retirement funds, automobiles, and personal property
- **Liabilities**, which are financial obligations or **debts** owed by a borrower (Debts are recurring monetary obligations that cannot be canceled plus any installment debts with 10 or more payments left.)
- Details of the **real estate transaction** itself, including purchase price, closing costs, prepaid items (e.g., escrows for taxes and insurance), estimated closing costs, mortgage insurance, secondary financing, etc.

The completion of a loan application triggers federal disclosure requirements.

Federal Lending Legislation

Real estate licensees should have some familiarity with key provisions of these federal laws that impact residential real estate transactions:

- Truth in Lending Act (TILA)
- Real Estate Settlement Procedures Act (RESPA)
- Equal Credit Opportunity Act (ECOA)
- Dodd-Frank Wall Street Reform and Consumer Protection Act

Truth in Lending Act (TILA)

The **Truth in Lending Act** was enacted as Title I of the Consumer Credit Protection Act in 1968 and implemented by **Regulation Z.** It requires a lending institution to disclose to the borrower the **actual, total costs involved in acquiring credit.** TILA is enforced by the Consumer Financial Protection Bureau.

TILA applies to all real estate loans made to consumers primarily for **personal, family, or household purposes** if the loan is subject to a finance charge or payable by written agreement in more than four installments. TILA does not apply to the following types of transactions:

- Business, commercial, or agricultural loans
- Loans payable with four or fewer installments
- Loans without finance charges
- Loans made to corporations, partnerships, associations, and agencies
The purpose of TILA's requirement to disclose consumer credit costs is to **promote the informed use of consumer credit**. While Reg Z does not set limits on interest rates or other finance charges, it does regulate the disclosure of these items. Disclosures are required when lenders **offer credit** to borrowers (on the **Loan Estimate** form, which will be discussed shortly) and when credit terms are **advertised** to potential customers.

### Advertising Disclosures

Under Regulation Z, certain financing terms in an advertisement trigger the need for additional disclosure. The following examples would be considered triggering terms:

- 4% interest rate
- $500 down payment
- $350 monthly payments

Use of general statements such as "low down payment," "affordable rates," or "easy terms" does not invoke the requirement for full disclosure, nor does the inclusion of a property’s list price.

The use of any **triggering term** in an advertisement requires **full financial disclosure**, including:

- Down payment requirement and annual percentage rate (APR)
- Type of loan (conventional, FHA, VA)
- Terms of the loan and monthly payments
- Loan origination fees and discount points to be paid by the borrower
- Mortgage insurance premiums or any additional charges to be paid by the borrower

Generally speaking, real estate licensees should refrain from including any financing terms or conditions in advertising.

### Right of Rescission

**Rescission** is the cancellation or termination of a contract. Under Reg Z, some borrowers have the right of rescission for **three business days** after a loan contract is signed. This right applies mostly to borrowers who are **refinancing** or obtaining **home equity loans**, not for purchase loans. In addition, the Truth in Lending Act gives the right of rescission to borrowers who have **not** been provided full disclosure. In some cases, they could have this right for **three years** after the loan contract is signed.

### Real Estate Settlement Procedures Act (RESPA)

The **Real Estate Settlement Procedures Act**, or RESPA, was passed by Congress in 1974 and implemented as **Regulation X** to protect consumers by requiring lenders to disclose **actual closing costs** in a timely manner. RESPA, also enforced by the Consumer Financial Protection Bureau, applies to any **federally-related mortgage loan** secured by a first or subordinate lien on a residential real property designed for **one to four families**.
RESPA does not apply to the following:

- Loans used to finance the purchase of 25 acres or more
- Loans for purchase of vacant land
- Transactions where the buyer takes over (or assumes) an existing first lien loan

The purpose of RESPA is to help consumers become better shoppers for settlement services and to eliminate unnecessary increases in the costs of certain settlement services due to kickbacks and referral fees. Like TILA, RESPA requires lenders to deliver various disclosures at specified times during the loan process.

RESPA’s provisions related to settlement are a separate topic and are addressed in Chapter 18, Closing Real Estate Transactions. In this chapter, we focus on loan disclosure mandates only.

**RESPA Disclosures**

**At Application (within 3 business days, unless the borrower withdraws the application)**

- A special information booklet, called Your Home Loan Toolkit
- The Loan Estimate, which includes a good faith estimate of closing costs
- A Mortgage Servicing Disclosure Statement, which informs the borrower whether the lender intends to service the loan, sell, or transfer servicing to another entity
- An Affiliated Business Arrangement (AfBA) Disclosure, if the lender has an affiliation or beneficial ownership interest of more than 1% in a settlement services provider to whom the borrower is referred

**Prior to Settlement**

- The Affiliated Business Arrangement (AfBA) Disclosure must be provided at or before the time of referral.
- The Closing Disclosure, which is a settlement statement showing the finalized costs of the loan transaction, must be provided three business days prior to loan consummation.

**At Settlement**

- A finalized Closing Disclosure
- An Initial Escrow Statement that itemizes the estimated taxes, insurance premiums, and other charges anticipated to be paid from the escrow account during the first 12 months of the loan (generally given at closing, but must be presented within 45 days of closing)

**After Settlement**

- Annual Escrow Statement
- Servicing Transfer Statement

Until the Loan Estimate and other required disclosures are delivered to the borrower, a loan originator may charge the borrower a fee only for the actual cost of obtaining a credit report.

**The TRID Rule**

In 2013, the Consumer Financial Protection Bureau (CFPB) issued a final rule to integrate disclosures and regulations required by the Real Estate Settlement Procedures Act and the Truth in Lending Act. The purpose of the final rule, called TILA-RESPA Integrated Disclosure (TRID), is to improve consumer understanding of the mortgage process, aid in comparison shopping, and help to prevent surprises at the closing table.
The TRID rule does not apply to:

- Home equity lines of credit (HELOCs)
- Mortgages on mobile homes
- Reverse mortgages

The TRID rule mandates that lenders provide consumers with a Loan Estimate disclosure no later than three business days after the lender receives the borrower's completed application. The TRID Loan Estimate replaces the initial Truth in Lending Statement, required by the Truth in Lending Act, and the Good Faith Estimate, required by RESPA, that were standard in the mortgage industry for decades.

RESPA prohibits lenders and servicers from charging a fee for the preparation of the Loan Estimate or other disclosures required by the Truth in Lending Act and RESPA, such as the Closing Disclosure, or annual escrow account statements.

**TILA Disclosures on the Loan Estimate**

The main TILA disclosure on the Loan Estimate is the annual percentage rate (APR). The APR disclosure appears on Page 3 of the sample Loan Estimate. Other details required by TILA include the following:

- Amount financed
- Total finance charges
- Number, amount, and due dates of payments
- New payment, late payment, and prepayment provisions
- Description and identification of security (mortgaged property or other collateral)

**RESPA Disclosures on the Loan Estimate**

To comply with the Real Estate Settlement Procedures Act, the Loan Estimate must also include the critical data a borrower needs to shop for settlement services and determine the best loan, for example:

- The dates the specific interest rate is available
- A concise summary of the terms of the loan
- Whether the interest rate can rise under certain circumstances
- Whether the lender requires an escrow account for taxes and hazard insurance
- The total estimated settlement charges, which is generally the amount of money necessary to bring to settlement in addition to funds for the down payment

**Availability of Terms in the Loan Estimate**

The estimate of the charges and terms for all settlement services must be available for at least 10 business days from when the Loan Estimate is provided. However, this 10 business-day provision does NOT apply to the interest rate and the charges and terms that are dependent upon the interest rate, such as adjusted origination charges and per diem interest. Because of this, borrowers and lenders frequently agree to a rate lock for a pre-determined timeframe.

If a borrower does not express intent to continue with an application within 10 business days after the Loan Estimate is provided, the loan originator is no longer bound by the terms of the proposed loan.
### Loan Estimate

**DATE ISSUED:** 2/15/2013  
**APPLICANTS:** Michael Jones and Mary Stone  
123 Anywhere Street  
Anytown, ST 12345  
**PROPERTY:** 456 Somewhere Avenue  
Anytown, ST 12345  
**SALE PRICE:** $180,000  
**SALE PRICE:** $180,000  

#### Loan Terms

<table>
<thead>
<tr>
<th>Term</th>
<th>Amount</th>
<th>Increase after closing?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan Amount</strong></td>
<td>$162,000</td>
<td>NO</td>
</tr>
<tr>
<td><strong>Interest Rate</strong></td>
<td>3.875%</td>
<td>NO</td>
</tr>
<tr>
<td><strong>Monthly Principal &amp; Interest</strong></td>
<td>$761.78</td>
<td>NO</td>
</tr>
</tbody>
</table>

#### Projected Payments

<table>
<thead>
<tr>
<th>Payment Calculation</th>
<th>Years 1-7</th>
<th>Years 8-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; Interest</td>
<td>$761.78</td>
<td>$761.78</td>
</tr>
<tr>
<td>Mortgage Insurance</td>
<td>+ 82</td>
<td>+ —</td>
</tr>
<tr>
<td>Estimated Escrow</td>
<td>+ 206</td>
<td>+ 206</td>
</tr>
</tbody>
</table>

**Estimated Total Monthly Payment:**  
$1,050 (Years 1-7)  
$968 (Years 8-30)

**Estimated Taxes, Insurance & Assessments:**  
$206 a month  
*Amount can increase over time*

**This estimate includes:**  
- Property Taxes  
- Homeowner’s Insurance  
- Other: See Section G on page 2 for escrowed property costs. You must pay for other property costs separately.

**In escrow?**  
- YES

#### Costs at Closing

**Estimated Closing Costs:**  
$8,054  
Includes $5,672 in Loan Costs + $2,382 in Other Costs – $0 in Lender Credits. See page 2 for details.

**Estimated Cash to Close:**  
$16,054  
Includes Closing Costs. See Calculating Cash to Close on page 2 for details.
## Closing Cost Details

### Loan Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Origination Charges</td>
<td>$1,802</td>
</tr>
<tr>
<td>.25% of Loan Amount (Points)</td>
<td>$405</td>
</tr>
<tr>
<td>Application Fee</td>
<td>$300</td>
</tr>
<tr>
<td>Underwriting Fee</td>
<td>$1,097</td>
</tr>
</tbody>
</table>

### B. Services You Cannot Shop For | $672 |

- Appraisal Fee | $405 |
- Credit Report Fee | $30 |
- Flood Determination Fee | $20 |
- Flood Monitoring Fee | $32 |
- Tax Monitoring Fee | $75 |
- Tax Status Research Fee | $110 |

### C. Services You Can Shop For | $3,198 |

- Pest Inspection Fee | $135 |
- Survey Fee | $65 |
- Title – Insurance Binder | $700 |
- Title – Lender’s Title Policy | $535 |
- Title – Settlement Agent Fee | $502 |
- Title – Title Search | $1,261 |

### D. TOTAL LOAN COSTS (A + B + C) | $5,672 |

### Other Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>E. Taxes and Other Government Fees</td>
<td>$85</td>
</tr>
<tr>
<td>Homeowner’s Insurance Premium</td>
<td>$605</td>
</tr>
<tr>
<td>Mortgage Insurance Premium</td>
<td>$262</td>
</tr>
<tr>
<td>Prepaid Interest</td>
<td>$17.44 per day for 15 days @ 3.875%</td>
</tr>
</tbody>
</table>

### F. Prepaids | $867 |

- Homeowner’s Insurance Premium (6 months) | $605 |
- Mortgage Insurance Premium (months) | $262 |
- Prepaid Interest (17.44 per day for 15 days @ 3.875%) | $17.44 |

### G. Initial Escrow Payment at Closing | $413 |

- Homeowner’s Insurance Premium | $100.83 per month for 2 months |
- Mortgage Insurance Premium | $105.30 per month for 2 months |
- Property Taxes | $41.41 per month for 2 months |

### H. Other | $1,017 |

- Title – Owner’s Title Policy (optional) | $1,017 |

### I. TOTAL OTHER COSTS (E + F + G + H) | $2,382 |

### J. TOTAL CLOSING COSTS | $8,054 |

\[ \text{D + I} \]

- Lender Credits | $0 |

### Calculating Cash to Close

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Closing Costs (J)</td>
<td>$8,054</td>
</tr>
<tr>
<td>Closing Costs Financed (Paid from your Loan Amount)</td>
<td>$0</td>
</tr>
<tr>
<td>Down Payment/Funds from Borrower</td>
<td>$18,000</td>
</tr>
<tr>
<td>Deposit</td>
<td>$10,000</td>
</tr>
<tr>
<td>Funds for Borrower</td>
<td>$0</td>
</tr>
<tr>
<td>Seller Credits</td>
<td>$0</td>
</tr>
<tr>
<td>Adjustments and Other Credits</td>
<td>$0</td>
</tr>
</tbody>
</table>

### Estimated Cash to Close | $16,054 |
### Additional Information About This Loan

<table>
<thead>
<tr>
<th>LENDER</th>
<th>Ficus Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOAN OFFICER</td>
<td>Joe Smith</td>
</tr>
<tr>
<td>EMAIL</td>
<td><a href="mailto:joesmith@ficusbank.com">joesmith@ficusbank.com</a></td>
</tr>
<tr>
<td>PHONE</td>
<td>123-456-7890</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MORTGAGE BROKER</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LOAN OFFICER</td>
<td></td>
</tr>
<tr>
<td>EMAIL</td>
<td></td>
</tr>
<tr>
<td>PHONE</td>
<td></td>
</tr>
</tbody>
</table>

### Comparisons

Use these measures to compare this loan with other loans.

<table>
<thead>
<tr>
<th>In 5 Years</th>
<th>$56,582 Total you will have paid in principal, interest, mortgage insurance, and loan costs.</th>
<th>$15,773 Principal you will have paid off.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Percentage Rate (APR)</td>
<td>4.274% Your costs over the loan term expressed as a rate. This is not your interest rate.</td>
<td></td>
</tr>
<tr>
<td>Total Interest Percentage (TIP)</td>
<td>69.45% The total amount of interest that you will pay over the loan term as a percentage of your loan amount.</td>
<td></td>
</tr>
</tbody>
</table>

### Other Considerations

- **Appraisal**: We may order an appraisal to determine the property's value and charge you for this appraisal. We will promptly give you a copy of any appraisal, even if your loan does not close. You can pay for an additional appraisal for your own use at your own cost.

- **Assumption**: If you sell or transfer this property to another person, we
  - [ ] will allow, under certain conditions, this person to assume this loan on the original terms.
  - [x] will not allow assumption of this loan on the original terms.

- **Homeowner's Insurance**: This loan requires homeowner's insurance on the property, which you may obtain from a company of your choice that we find acceptable.

- **Late Payment**: If your payment is more than 15 days late, we will charge a late fee of 5% of the monthly principal and interest payment.

- **Refinance**: Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

- **Servicing**: We intend
  - [ ] to service your loan. If so, you will make your payments to us.
  - [x] to transfer servicing of your loan.

### Confirm Receipt

By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

| Applicant Signature | Date | Co-Applicant Signature | Date |
Loan Estimate Waiting Periods

There is a mandatory **seven-day waiting period** from the time the MLO delivers the required Loan Estimate to a borrower before a home loan can close.

Once a Closing Disclosure has been delivered to the borrower, if the initial APR or other specific terms change by a statutory amount, an updated Closing Disclosure will be required, after which the borrower is given another **three business-day period** to review the disclosures before the loan can close.

A borrower may be able to wa**ive** the waiting periods and expedite the closing if there’s a **bona fide personal financial emergency**, such as to avoid foreclosure.

> These are statutory waiting periods. In reality, it could take 45 days or more to close a real estate transaction.

Equal Credit Opportunity Act (ECOA)

The **Equal Credit Opportunity Act**, implemented as **Regulation B**, ensures that all consumers are given an equal chance to obtain credit. The ECOA prohibits anyone who grants credit or sets the terms of that credit from discrimination against **individuals** and **businesses** on these terms:

- Race
- Color
- Religion
- National origin
- Age (provided applicant has the capacity to contract, i.e., 18 years old)
- Sex
- Marital status
- Receipt of income from public assistance programs (as long as the income is stable)
- Exercised rights under the Consumer Credit Protection Act

As a matter of fact, the law indicates that someone cannot even be **discouraged from applying for credit** based on any of these factors.

The ECOA requires creditors to notify applicants of their lending decision—whether credit was extended or rejected—**within 30 days of the filing of a complete application**. It also gives consumers the right to receive a copy of any **appraisal report** on the property that was used in the decision-making process.

Community Reinvestment Act (CRA)

**Redlining** is the illegal refusal to make loans or provide insurance on property located in certain neighborhoods for discriminatory reasons. This discriminatory practice was addressed in 1977 with the passage of the **Community Reinvestment Act (CRA)**. This law was designed to ensure that financial institutions take responsibility in meeting their respective communities’ needs for low-income and moderate-income housing consistent with safe and sound lending practices.

The CRA requires lenders to be able to demonstrate that they are helping to meet the credit needs of the entire community. Their records must prove that they comply with this legislation. Lenders may still deny loans in neighborhoods where property values are declining, but the rejection must be based on objective criteria regarding the condition and value of the property or area.
Wall Street Reform and Consumer Protection Act

The purpose of the comprehensive Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 was to promote financial stability by improving accountability and transparency in the financial system. Two of its titles have changed the landscape of the mortgage industry forever:

- The Consumer Financial Protection Act created the Consumer Financial Protection Bureau, whose task is to enforce consumer financial protection laws. Although the CFPB is funded by the Federal Reserve, it is intended to function independently. The CFPB has rule-making authority for Regulation Z, Regulation X, Regulation B, and others.

- The Mortgage Reform and Anti-Predatory Lending Act takes several steps to address what Congress considers to be abusive or predatory lending practices. Now, mortgage lenders must determine—based on “verified and documented information”—that the borrower has a “reasonable ability to repay” the loan. Under certain circumstances, a borrower could use the violation of this section as a defense against foreclosure.

Ability to Repay Rule

Under provisions of the Dodd-Frank Act, lenders may not grant loans solely based on the collateral value of the borrower’s property without regard to the borrower’s ability to repay the loan, including the borrower’s current and reasonably expected income, employment status, assets other than the collateral, current obligations, and mortgage-related obligations, which include expected property taxes, premiums for mortgage-related insurance required by the lender, and similar expenses. Lenders must verify the information an applicant provides using reliable documents such as a W-2 or a pay stub.

A lender is presumed to have met the ability-to-repay requirements by making a “qualified mortgage” that does not include certain risky features, for example, a period where the borrower pays only interest on the loan, the need for a lump sum balloon payment at the end of the loan term, or a loan term that exceeds 30 years.

Loan Qualification

Before making real estate loans, lenders evaluate borrowers to make sure they meet minimum qualifying standards. Qualifying standards can vary from lender to lender, but with lenders’ increased dependence on selling their loans to the national secondary mortgage markets, a high degree of standardization has developed.

When lenders first meet with a potential borrower—either for pre-qualification or pre-approval—they will likely perform an analysis of the current or allowable monthly housing expense based on the borrower’s income and debt. This provides the lender—and the borrower—with a realistic understanding of what mortgage payment the borrower may be able to afford.
Income

To ensure a borrower has sufficient income to repay the debt, the lender will first consider the borrower's **stable monthly income**, which is

- Any income that can reasonably be expected to **continue for the foreseeable future**.
- Usually based on the borrower's **gross monthly income** (before any taxes or other deductions).
- **Verifiable** by the borrower's employer and federal tax returns.

A **quality** source of income is one that is reasonably reliable, such as income from an established employer, government agency, interest-yielding investment account, etc. A **durable** source of income can be expected to continue for a sustained period. (Remember that lenders may not discriminate on the source of a borrower's income.)

Self-employed borrowers need to provide personal and entity (corporation, partnership, sole proprietorship) **tax returns** (all schedules) for a **minimum of two years** to verify their income. Lenders often consider the lower of the two years when calculating qualifying ratios.

Debt

Debt is the other critical factor used to qualify a buyer. **Debt** is any **recurring monetary obligation that cannot be canceled**. Lenders consider existing and recurring long-term monthly debt as part of the borrower's obligation, for example:

- Installment loans for cars, furniture, and the like, usually with more than **10 payments** remaining (debts with fewer than 10 payments remaining may still be counted against the borrower if the payments are high, such as a $600 car payment)
- Credit card or retail account balances
- Child support or alimony payments
- Other mortgage loans

Utilities, cable service, and life insurance premiums are **not** considered debts because they can be canceled. Gray areas can include such things as doctor bills, which may be considered a debt if there is a payment schedule (e.g., for braces), or cell phone payments that account for the purchase of a device.

If the borrower has student loans currently in deferment, these need to be calculated as debt regardless of how soon the loans will be repaid.

Qualifying Ratios

There are two qualifying standards considered in underwriting:

- Housing expense ratio (also called the payment-to-income ratio or the front-end ratio)
- Total debt-to-income ratio (also called total debt service ratio or the back-end ratio)
Besides income and debt, the key element needed to calculate these ratios is **PITI**. To recall, PITI is an acronym for a mortgage payment that is the sum of monthly Principal, Interest, Taxes (ad valorem property taxes and perhaps mandatory special assessments, if applicable), and Insurance (homeowners hazard insurance and mortgage insurance, if applicable).

**Housing Expense Ratio**

A borrower’s **housing expense ratio** is *the relationship of the borrower’s gross monthly income to his total monthly housing expense expressed as a percentage*. Conventional lenders consider a borrower’s income adequate for a loan if the proposed total mortgage payment of PITI does not exceed **28%** of stable monthly income.

**For Example**

A loan applicant has $3,900 in stable gross monthly income. If the maximum housing expense ratio allowed for the loan is 28%, multiply gross monthly income by the housing expense ratio to find the total housing expense, or the maximum monthly PITI payment allowance:

\[
$3,900 \times 0.28 = 1,092
\]

Another borrower has a stable gross monthly income of $3,200. The loan on the house she wants to buy would have a monthly PITI payment of $980. What is the housing expense ratio for this loan?

\[
$980 \div $3,200 = 0.306
\]

This housing expense ratio exceeds the maximum for a conventional loan, but it might be acceptable for other loan programs, such as FHA-insured loans that have less stringent guidelines.

**Total Debt-to-Income Ratio**

A second but equally important concern when determining a buyer’s qualification for a conventional mortgage loan is the borrower’s total **debt-to-income ratio**. The total debt service ratio is usually a *more realistic measure* of the borrower’s ability to make the loan payments as it shows *the relationship of the borrower’s total monthly debt obligations (including PITI and long-term debts) to income, expressed as a percentage*. Conventional lenders want to be sure the borrower’s housing expenses plus other recurring monthly debt do not exceed **36%** of stable monthly income.
For Example

Our loan applicant has $3,900 in stable gross monthly income. If the maximum debt to income ratio allowed for the loan is 36%, multiply gross monthly income by the debt-to-income ratio to find the total debt allowance:

\[ $3,900 \times 0.36 = $1,404 \]

This does not mean that the borrower would qualify for a monthly PITI payment of $1,404. From that, you must subtract all recurring debts. This borrower has a $220 car payment and a $125 student loan payment, leaving him $1,059 for a mortgage payment (PITI):

\[ $1,404 - $220 - $125 = $1,059 \]

Borrowers must qualify under BOTH ratios. Therefore, the smaller of the two numbers would be the maximum allowable mortgage payment.

These qualifying standards could change. Also, note that lenders may consider other factors when underwriting a loan application, such as credit score. Always check with mortgage loan originators for the most current information.

Mortgage Factor Table

There are a variety of tools available to determine the monthly payment of principal and interest based on the loan amount and interest rate. At one time, every mortgage loan originator and quite a few real estate licensees would carry a mortgage factor table.

On this simplified version, interest rates are listed on the left column, and the terms of the loan are listed along the top. Look down the left column to find the interest rate that the buyer will be paying, and then look across to locate the term of the loan desired. The intersecting point of these two variables shows the factor (dollar amount) the buyer pays for every $1,000 of the financed amount (assuming a fixed rate loan). Other versions of a factor table may have more precise detail, for example showing the interest rates at one-eighth intervals (5 1/8, 5 1/4, 5 3/8, etc.) and/or the term on a year-by-year basis.

Once you know the factor, you can multiply it by the loan amount (per $1,000) to find the monthly payment for principal and interest (P&I).

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<th>15-YR</th>
<th>30-YR</th>
</tr>
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<td>3.69</td>
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<td>2 1/4</td>
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<td>2 3/4</td>
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<td>3 3/4</td>
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<td>4 3/4</td>
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</tr>
<tr>
<td>8%</td>
<td>9.56</td>
<td>7.34</td>
</tr>
</tbody>
</table>
For Example
The borrower is considering financing $155,000 on a 30-year fixed rate loan at 5 3/4%.
1. Find the factor from the table: 5.84
2. Divide the loan amount by $1,000 to get the loan amount per $1,000:
   \[ \frac{155,000}{1,000} = 155 \]
3. Multiply these two numbers to find the estimated monthly P&I payment for that loan:
   \[ 5.84 \times 155 = 905.20 \]
The P&I payment for this loan will be $905.20. Don’t forget that this is **principal and interest only**. When we were looking at qualifying standards, the monthly payment included taxes and insurance. It might also include homeowners association fees.

Underwriting
A borrower’s ability to qualify for a real estate loan depends on many factors. The primary concern throughout the loan underwriting process is determining the degree of risk a loan represents. The underwriter attempts to answer two fundamental questions:

- Is there sufficient value in the property pledged as collateral to assure recovery of the loan amount in the event of default?
- Does the borrower’s overall financial situation, which is comprised of credit, income, and assets, indicate a reasonable expectation of making the proposed monthly loan payments in a timely manner?

Credit Analysis
Credit history is a record of debt repayment, detailing how a person has paid credit accounts in the past as a guide to whether he or she is likely to pay accounts on time and as agreed in the future. Borrowers must inform a lender of all debts—even things that may not show up on a credit report.

As part of the loan evaluation, the underwriter analyzes the borrower’s and any co-borrower’s credit history by obtaining a credit report from a national credit bureau (e.g., Experian, Equifax, and TransUnion). If the credit history shows a slow payment record or other derogatory credit information (lawsuit, judgment, repossession, collection, foreclosure, or bankruptcy), a loan application could be declined or the borrower could be put into a **high-risk** (known as **B-C credit**) category.

Credit Scoring
Credit scoring is an objective means of determining the creditworthiness of potential borrowers based on a number system. A credit score is a numeric representation of the borrower’s credit profile compiled by assigning specified numerical values to different aspects of the borrower. These numbers are adjusted up and down based on the strengths and weaknesses of specific qualifications, and a credit score based on these various criteria is assigned.
Credit scores also play an important role in automated underwriting, since Fannie Mae and Freddie Mac have identified a strong correlation between mortgage performance and credit scores. The higher the credit score, the better credit risk a borrower is; the lower the score, the higher the risk of default.

FICO is a credit score developed by Fair, Isaac & Co. While not used by every credit reporting agency, FICO is a common term that is often used generically.

Calculating Credit Scores

A credit score is the result of very complex calculations carried out by a computer that considers every aspect of the borrower's credit file, such as:

- Number of open accounts
- Total credit limit
- Types of credit (e.g., credit cards, installment loans)
- Length of credit history (e.g., when opened, latest activity)
- Total amount of debt outstanding
- Number of late payments in the past 30-60-90 days
- Presence of adverse public records (e.g., liens, judgments, or bankruptcies)
- Number of recent credit inquiries
- Re-establishment of positive credit history after past payment problems

Derogatory Credit

While Fannie Mae and Freddie Mac will likely not accept loans from borrowers with a credit score below 620, poor credit doesn't always stop a loan if credit problems can be explained to a lender's satisfaction. The circumstances causing the problems may have been temporary—such as loss of a job, hospitalization, prolonged illness, death in the family, or divorce—and no longer exist. If prior and subsequent credit ratings have been good, the loan application might be approved. Perpetual credit problems, however, could reflect an attitude instead of a circumstance, and lenders may presume this will continue.

Bankruptcy

Bankruptcy, as established by Title 11 of the United States Code, is a court process that cancels debt and provides some relief for creditors. There are two basic proceedings for individuals:

- **Chapter 7.** Sometimes called straight bankruptcy, this is a liquidation proceeding. The debtor turns over all nonexempt property to the bankruptcy trustee, who then converts it to cash for distribution to the creditors. The debtor receives a discharge of all dischargeable debts, usually within four months. Someone wishing to file Chapter 7 must meet certain criteria related to income and debt.

- **Chapter 13.** This is filed by individuals who want to pay off their debts over a period of three to five years. This is preferable to those who have nonexempt property that they want to keep. It is only an option for individuals who have predictable income and whose income is sufficient to pay their reasonable expenses with some amount left over to pay off their debts.
FAIR CREDIT REPORTING ACT The federal Fair Credit Reporting Act indicates that consumer reporting agencies may maintain bankruptcy information on a consumer's credit report for no more than 10 years from the date of entry of the order for relief or the date of adjudication, whichever the case may be. While credit reporting agencies do keep completed Chapter 7 bankruptcies on the credit report for the maximum 10 years, they often keep Chapter 13 bankruptcies on the credit report only for seven years after the discharge date. This is an incentive for a consumer to file under Chapter 13 and repay their debts.

Assets
Assets are simply items of value. If a borrower has a marginal debt-to-income ratio, above average assets can offset this deficiency. Underwriters know that assets—especially in liquid forms such as savings, trust funds, stocks, or bonds—can be used to pay unexpected bills or to support a borrower when there's a temporary interruption in income. Documentation of assets usually includes one to two months of bank statements (all pages) to verify available funds. A Verification of Deposit (VOD) form may also be used to verify bank statement balances, both current balance and average balance.

There are three aspects of a borrower's assets in which lenders and underwriters are interested: Down payment, reserves, and other assets.

Down Payment
Underwriters must determine that the borrower has sufficient liquid assets to make the cash down payment and pay the closing costs and other expenses incidental to the purchase of the property. Most loan programs require the borrowers to bring at least 5% of the down payment from their own personal savings into the transaction. There are some programs that allow a smaller down payment—mostly government programs or those geared to first-time homebuyers.

The lender also wants to know the source of the borrower's down payment. Savings or sale of a prior home are both acceptable sources of down payment. Borrowed funds must be secured and the debt considered in the debt-to-income ratio. If an applicant lacks the necessary funds to close a transaction, a gift of the required amount is usually acceptable to the underwriter. Gift funds must come through a traceable process; cash is not acceptable. The gift should also be confirmed by means of a gift letter signed by the donor. The letter should clearly state that the money represents a gift and does not have to be repaid.

Don't confuse down payment with earnest money deposit. Buyers provide earnest money with an offer to show their seriousness to the seller. Buyers make down payments to the lender. Both sums will be reconciled at settlement as a credit to the buyer.

Reserves
Reserves are cash on deposit or other highly liquid assets a borrower will have available after the loan funds. Many lenders prefer borrowers to have enough in reserve to cover two months' PITI mortgage payments after the borrower makes the down payment and pays all closing costs.
Other Assets

Having assets in addition to cash and other liquid assets shows that the borrower can manage money and has resources, if needed, to handle emergencies and make mortgage payments. For example, real estate equity is an important asset for underwriters to consider. Equity is the difference between the market value of the property and the sum of the mortgages and other liens against the property. Equity, less all selling expenses, is what a buyer should receive from the sale of property.

What is a Co-Mortgagor?

A co-mortgagor, also known as a co-borrower or co-signor, can aid a primary borrower in qualifying for a loan. A co-mortgagor accepts joint liability for the loan by signing the promissory note and mortgage. The co-mortgagor may not necessarily be an owner as well. In other words, the co-mortgagor does not have to be part owner of the property to be a borrower on the loan.

Like the primary borrower, a co-mortgagor must have income, assets, and credit history that are acceptable to the underwriter. Keep in mind that co-mortgagors must be able to pay their own housing expense and part, if not all, of the proposed housing expense. Co-mortgagors with marginal credit should not be relied on heavily and may do more harm than good to a loan application.

Automated Underwriting

Automation is used in all facets of the lending process. An automated underwriting system, or AUS, speeds up the approval process and provides consistent underwriting decisions using statistical computer models based on traditional underwriting factors. An AUS never considers factors such as race, ethnicity, age, or any other characteristic prohibited by law. With large databases of statistics and information available, an AUS can better manage credit risk by improving loan criteria.

The AUS makes a recommendation to accept a loan for delivery or refer it for an underwriter for further manual review and analysis. While lenders may rely on automated underwriting systems for a preliminary decision, it generally comes down to a human underwriter to examine the loan package and make the final decision to approve, reject, or approve the loan with conditions. Conditional approval usually requires the borrower to provide missing or additional items, such as a closing statement from the sale of the buyer's previous home, a final inspection report, or proof of insurance.

Conventional Loans

Conventional financing refers to real estate that is paid for or financed with a conventional loan, one that is usually made by a bank or institutional lender and not insured or guaranteed by a government entity or agency. Conventional loans may be conforming or nonconforming, however, most conventional loans are written to the following guidelines set by government-sponsored enterprises such as Freddie Mac and Fannie Mae so that they may be sold into the secondary market:

- Housing Expense Ratio (PITI) not to exceed 28% of gross monthly income
- Debt-to-Income Ratio (PITI + recurring debt) not to exceed 36% of gross monthly income
It’s common for conventional loans to contain an alienation clause. Therefore, they are rarely assumable.

Loan Terms
Conventional loans are typically fully amortized, fixed rate, and long-term, meaning they generally have total payments spread out over 25 to 30 years, and sometimes even 40 years.

Some borrowers prefer a 15-year conventional loan. Lenders will often give a better interest rate because the shorter term means less risk for the lender. Over the life of the mortgage, the total interest paid on a 15-year, fixed rate mortgage is about one-third less than a 30-year mortgage at the same interest rate. Of course, there are disadvantages to 15-year mortgages:

- The monthly payments are higher, which consume financial resources that might be invested in other ways and earn a higher return than the interest rate paid on the mortgage.
- The borrower loses the income tax deduction more quickly because the home is paid for sooner.

BIWEEKLY PAYMENT PLANS A mortgage loan with a biweekly payment plan is a fixed rate loan set up like a standard 30-year conventional loan, but payments are made every two weeks instead of every month. Over the course of a year, that adds up to 26 payments, which is equal to one extra monthly payment. Loans with biweekly payments are usually paid off in about 22.3 years instead of 30 years. Some borrowers prefer this alternative financing tool to reach the goal of paying off a loan earlier and paying less interest.

A disciplined borrower with a 30-year loan can make additional payments of principal whenever convenient. This will pay off the loan more quickly, thus reducing the total interest paid, without the disadvantages of a 15-year term or a bi-weekly mortgage.

Loan-to-Value (LTV)
Loans are classified by the relationship between the amount of money being loaned and the value of the property. This is known as the loan-to-value ratio, or LTV.

Lenders use LTV to determine how much they are willing to loan on a given property based on its value. Lenders define property value as the appraised value or the sales price, whichever is less.

The lender will always use the lower of those two numbers to protect its interest: The lower the LTV, the higher the borrower’s down payment, which means the loan is more secure.

The 80% conventional loan, which is a loan with an 80% LTV, has been the standard conventional loan for many years. With this type of loan, the buyer makes a 20% down payment and obtains a 30-year, fixed rate conventional loan for the balance of the purchase price.
For Example

What happens when the appraised value is less than the sales price? Let’s say a seller accepts a buyer’s offer of $164,500 to buy a home. The appraisal on the property comes in at $163,000. If the lender requires an LTV of 80%, the maximum loan amount is $130,400 ($163,000 x 0.80). To purchase this home at the contract price, the buyer would have to make a down payment of $34,100:

$$164,500 - 130,400 = 34,100$$

When LTV is Too High

When the loan-to-value is greater than 80%, there are other ways a borrower can move forward with the transaction:

- The seller can assist the borrower (seller financing).
- The seller could lower the sales price.

Alternatively, a borrower who does not have enough money for a 20% down payment but still wants a conventional loan can try to get a 90% conventional loan with a 10% down payment, a 95% conventional loan with a 5% down payment, or even a 100% conventional loan. Loans with an LTV higher than 80% are possible because of private mortgage insurance (PMI) and secondary financing.

The qualifying standards for higher LTV loans tend to be more stringent. Also, these loans may also have a higher interest rate, call for higher loan origination fees, or impose additional conditions and standards.

Private Mortgage Insurance

Private mortgage insurance (PMI) is offered by private companies to insure a lender against default on a loan by a borrower. Prior to the advent of PMI, lenders would lend only 80% of the value of a property, assuming that the 20% down payment was an incentive for the borrower to keep loan payments current. Lenders also felt comfortable that, in the event of default, a foreclosure sale would yield 80% of the original sale price (or appraised value) to recover the loan amount. PMI evolved to compensate the lender for the reduced borrower equity, thus making loans easier for borrowers and safer for lenders.

When insuring a loan, the mortgage insurance company shares the lender’s risk, but only part of the risk. The insurer does not insure the entire loan amount but rather the upper portion of the loan that exceeds the standard 80% LTV. The amount of coverage can vary, but it is typically 20% to 25% of the loan amount.

PMI Premiums

The traditional way that private mortgage insurance companies charge for PMI is with a one-time fee at closing when the loan is made and a recurring fee, called a renewal premium, that’s added to the borrower’s monthly mortgage payment. Some PMI insurers offer a one-time mortgage insurance premium, with no renewal fee.
Combining the initial premium and renewal premiums into one payment allows the borrower to finance the PMI premium. When the PMI premium is financed, monthly payments may still be lower than if the renewal premiums are added to the regular mortgage payment.

**PMI Cancellation**

Once the increased risk of borrower default is gone (when the loan-to-value ratio is reduced to 80% or less), private mortgage insurance has fulfilled its purpose. The **Homeowners Protection Act of 1998 (HPA)** requires lenders to automatically cancel PMI when a home has been paid down to 78% of its original value, assuming the borrower is not delinquent. The law also requires lenders to drop PMI coverage at a borrower’s request when the loan has been paid down to 80% or less of the home’s value and mortgage payments are current.

As is often the case, the law sets a minimum standard, but the market may move the bar higher. For example, Fannie Mae and Freddie Mac will consider the present value of the home, not just the original value as required by law. This effectively cancels PMI more quickly, assuming the home appreciates. However, not all lenders follow these guidelines.

**Secondary Financing**

Since many buyers are reluctant to pay for private mortgage insurance, some lenders allow alternatives to avoid PMI. So-called 80/10 or 80/20 mortgages, sometimes called piggyback loans, allow a borrower to take out an 80% first loan and a 10% or 20% second loan. With secondary financing, a buyer borrows money from another source to pay part of the purchase price or closing costs. The source can be a lender or even the seller. This is another way a borrower can get a conventional loan without a 20% down payment.

When underwriting a loan with secondary financing, the primary lender will consider the payment on the second loan as part of the borrower’s monthly housing expense. The total amount borrowed is known as the combined loan-to-value (CLTV).

Most primary lenders require secondary financing to have a subordination clause to ensure that the primary lender’s lien will take priority, even if the second mortgage is recorded first.

**Government Loan Programs**

Several government loan programs offer a real alternative to borrowers who either don’t qualify for a conventional loan or who are looking for a better deal. The primary government finance programs are loans insured by the **Federal Housing Administration (FHA)** and loans guaranteed by the **U.S. Department of Veterans Affairs (VA)**. Other specialized loan programs exist as well.

Don’t confuse these programs with government-sponsored enterprises such as Fannie Mae and Freddie Mac and their involvement in the secondary mortgage markets.
FHA-Insured Loans

The public has several misconceptions about FHA loans. The Federal Housing Administration rarely provides mortgage funds directly to borrowers; the FHA does not build houses, nor does the FHA set interest rates. Instead, the Federal Housing Administration insures loans for one- to four-family homes made by approved lenders (called Direct Endorsers).

Another common misconception about FHA loans is that they are targeted to lower-income borrowers or first-time homebuyers only, but this is not the case. The Federal Housing Administration does NOT have income limits to determine who is eligible for FHA-insured loans. Anyone who is a U.S. citizen, permanent resident, or nonpermanent resident with a qualifying work visa, and who meets the lending guidelines can obtain a loan.

FHA qualifying standards are less stringent than the Fannie Mae and Freddie Mac requirements for conforming loans. A borrower who would be considered marginal by Fannie Mae and Freddie Mac standards might qualify more easily for an FHA loan.

While borrower qualifying standards are less stringent, FHA-insured loans may be difficult to get for certain properties that do not meet FHA’s guidelines related to property condition.

Mortgage Insurance Premium

A mortgage insurance premium (MIP)—not to be confused with private mortgage insurance (PMI) for conventional loans—is required for all FHA-insured loans, regardless of the down payment. There is an initial premium, called the upfront mortgage insurance premium (UFMIP), that must be paid at closing or financed as part of the loan. In addition, FHA-insured loans impose a monthly mortgage insurance premium on the balance. The monthly MIP is based on the LTV and the loan term. So, for example, a 30-year mortgage with a 95% LTV has a higher MIP than a 15-year mortgage with a 90% LTV.

FHA-Insured Loans

<table>
<thead>
<tr>
<th>Down Payment</th>
<th>At least 3.5% of the home’s purchase price or appraised value, whichever is less (i.e., maximum LTV of 96.5%) from an acceptable source; may be non-repayable gift from relative, employer or labor union, charitable organization, or close friend</th>
</tr>
</thead>
</table>
| Qualifying Standards | Maximum housing expense ratio (PITI) = 31%  
Maximum total debt-to-income ratio (PITI + Debt) = 43% |
| Property Eligibility | One- to four-family dwellings; if multi-unit dwelling, borrower must live in one of the units as the principal residence |
| Occupancy | Must establish bona fide occupancy as principal residence within 60 days; required to live in the house for at least one year |
| Maximum Mortgage Amount (Loan Ceiling) | Set by HUD based on the community; boundaries may be based on county, zip code, or metropolitan statistical area (MSA); limits are reviewed periodically. |
| Prepayment Penalties | Prohibited |
| Loan Assumption | Allowed with FHA credit review |
FHA Loan Programs

FHA has several loan programs. The most common include:

- **FHA 203(b).** A basic fixed-rate loan. HUD limits maximum loan amounts for 203(b) loans, depending on median range housing costs for each area. Different loan ceilings apply for single-family and two-, three-, or four-unit dwellings.

- **FHA 243(c).** A basic fixed-rate loan for a condominium.

- **FHA 251.** An adjustable rate (ARM) loan. FHA ARM loans are limited to one- to four-family dwellings or condominiums. Using an ARM with an FHA mortgage does not affect maximum mortgage limits, LTV ratios, mortgage insurance premiums (MIP), or borrower qualifications. ARM loans are also restricted to owner occupants.

- **FHA 203K.** A loan structured to allow the buyer to purchase the home and borrow enough money for the purchase price, plus renovation expenses.

VA-Guaranteed Loans

**VA-guaranteed loans** are guaranteed by the federal government through the Veterans Benefits Administration, which is part of the Department of Veterans Affairs. The VA’s main purpose in guaranteeing loans is to help meet the housing needs of eligible veterans who have served or are currently serving on active duty in the U.S. Armed Forces, which includes: Army, Navy, Air Force, Marine Corps, Coast Guard, Reserves, or National Guard.

While there is no upfront or monthly mortgage insurance premiums required for VA-guaranteed loans, borrowers must pay a one-time variable funding fee at closing for guaranteeing the loan. The variable funding fee is waived for disabled veterans and surviving spouses of veterans who died in service or from service-connected disabilities.

The VA rarely lends money directly to borrowers. It may do so in isolated rural areas where financing isn’t readily available, but usually, a veteran must borrow money from a VA-approved lender.

Eligibility

Lenders may not process or close a VA-guaranteed loan without verifying the eligibility of the borrower with a **Certificate of Eligibility** (COE) issued by the VA. To be eligible for a VA-guaranteed loan, the borrower must have completed a minimum number of days of active duty—generally more than 180 days in peacetime or at least 90 days in wartime—and must not have been dishonorably discharged. Most commonly, this is evidenced by a Certificate of Release or Discharge from Active Duty, or **DD-214**, issued by the Department of Defense. The DD-214 identifies the character of service and reason for discharge (honorable, dishonorable, etc.).

As with any mortgage loan, the value of the collateral being used to secure the note is critical. An appraisal is required to help ensure that any property that will become the security for a VA-guaranteed loan has a value of at least as much as the loan amount and that it is in a condition acceptable to the VA. Every appraisal made for VA purposes must be reviewed either by the lender’s VA-authorized staff appraisal reviewer or a VA staff appraiser, who then issues a **Notice of Value** (NOV) or a **Certificate of Reasonable**
**Value (CRV).** Every CRV issued in conjunction with an appraisal review must include a list of any conditions and requirements that must be satisfied for the property to be eligible for VA loan guarantee.

**Entitlement**

The VA doesn’t limit the price a veteran can pay for a house (assuming the house appraises for the loan amount), but the VA does limit the amount it will guarantee in case of default to 25% of the purchase price or the established reasonable value, whichever is less. A veteran’s **maximum guarantee amount**, known as **entitlement**, represents the portion of the loan that the VA guarantees in the event of default by the borrowing veteran. Therefore, veterans can generally purchase a home priced up to **four times** the amount of their entitlement, which is documented in the **Certificate of Eligibility**, with **no down payment**.

If the veteran’s remaining entitlement is insufficient—or if the purchase price exceeds the county limit—the veteran can make a down payment so that the combination of the entitlement and the down payment equals 25%. If the veteran is buying a home for greater than the CRV, the excess amount must be paid by the veteran in cash as a down payment.

**Funding Fee**

While there is no upfront or monthly mortgage insurance premiums required for VA-guaranteed loans, borrowers must pay a one-time **variable funding fee** at closing for guaranteeing the loan. The variable funding fee is due at closing or may be financed if the loan total does not exceed the CRV. The variable funding fee is waived for disabled veterans and surviving spouses of veterans who died in service or from service-connected disabilities.

**VA-Guaranteed Loans**

<table>
<thead>
<tr>
<th>Down Payment</th>
<th>Not required unless purchase price exceeds value</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Qualifying Standards</strong></td>
<td>Maximum housing expense ratio (PITI) = N/A</td>
</tr>
<tr>
<td></td>
<td>Maximum total debt-to-income ratio (PITI + Debt) = 41%</td>
</tr>
<tr>
<td></td>
<td>Minimum <strong>residual income</strong>: Amount of income a borrower has left after subtracting taxes, housing, and recurring debt obligations, based on regional guidelines</td>
</tr>
<tr>
<td><strong>Property Eligibility</strong></td>
<td>One- to four-family dwellings; if multi-unit dwelling, borrower must live in one of the units as the principal residence</td>
</tr>
<tr>
<td><strong>Occupancy</strong></td>
<td>Must establish bona fide occupancy as principal residence <strong>within 60 days</strong></td>
</tr>
<tr>
<td><strong>Maximum Mortgage Amount</strong></td>
<td>No more than 4x the veteran’s entitlement, shown in the Certificate of Eligibility (COE)</td>
</tr>
<tr>
<td><strong>Prepayment Penalties</strong></td>
<td>Prohibited</td>
</tr>
<tr>
<td><strong>Loan Assumption</strong></td>
<td>Allowed with VA approval; can be a non-veteran</td>
</tr>
</tbody>
</table>
USDA Rural Development Programs

USDA Rural Development, under the U.S. Department of Agriculture, administers financial programs for rural housing, community facilities, water and waste disposal, and rural businesses. Although one mission of Rural Development is to provide financial support to low-income homebuyers in rural communities, the definition of “rural” may be broader than one might think. It can include small towns up to 20,000 people, even those in areas that may be in close proximity to larger metropolitan areas. In addition, the USDA could determine that certain areas are temporarily eligible for their programs in response to temporary conditions or natural disasters.

USDA Section 502 Loans

The USDA Section 502 loan program either guarantees loans made by approved private lenders or makes direct loans if no local lender is available. Section 502 loans can be used for a variety of situations:

- Purchase or construct an existing home
- Renovate, repair, or relocate an existing home
- Purchase and prepare a site for a home, including sewage and water facilities

Applicants for Section 502 loans, both guaranteed and direct, must meet income requirements based on the area median income (AMI). Assuming the applicant meets the income eligibility and the house is in an approved area, the borrower may receive 100% financing, based on the appraised value or acquisition cost, whichever is less. Unlike FHA loans, these USDA loans do not require mortgage insurance of any kind. Borrowers must personally occupy the dwelling following the purchase. Dwellings must be structurally sound, functionally adequate, and in good condition.

Homebuyer Assistance Programs

Homebuyer assistance programs can provide down payment assistance, subsidized mortgage interest rates, help with closing costs, or a combination of services. These programs may be offered by the government or non-profit organizations to promote homeownership or by lenders as part of their obligation under the federal Community Reinvestment Act. Some programs allow people to buy homes with lower down payments than conventional loans, often 3% or less. These may be offered by cities, counties, or the state, with the money targeted to specific neighborhoods. Interest rate subsidies may also be obtained from a variety of sources. Some programs may even offer both down payment assistance and interest rate subsidies through various agencies.
First Time Homebuyer Loans or Community Homebuyer Programs are some of the
generic names for the various programs that lenders have created in response to the
Community Reinvestment Act. Under these programs, lenders show support for the
community by offering more flexible financing than they require for conforming loans
when considering credit, income, and down payment. Borrowers with poor credit may
have to complete a course on financial responsibility to qualify for a loan.

Challenge Activity

Indicate which loan program(s) is described by placing a checkmark in the appropriate box.

1. Maximum housing expense ratio of 31%.
2. PMI required if LTV is greater than 80%.
3. No down payment required.
4. Minimum down payment of 3.5% required.
5. Maximum debt-to-income ratio of 36%.
6. Mortgage insurance premium (MIP) required.
7. Occupancy required.
8. Residual income considered.
10. Loan assumption allowed.

Foreclosure and Short Sales

Borrowers who fail to repay the debt according to the terms of the agreement are
considered in default. The lender’s remedy for borrower default, in most cases, is some
type of foreclosure proceeding, which can differ depending on the laws of each state
and whether the security instrument is a mortgage or a deed of trust. Foreclosure
should be the last solution, as there are a number of alternatives, including a short sale.

The following is a general discussion on foreclosure actions. Every state has its
own laws that govern the requirements, timeframes, and procedures related
to foreclosure.
Judicial Foreclosure

A mortgage creates a lien against property as security for a debt. Generally, when a borrower fails to repay a debt according to the terms of the mortgage, the lender **accelerates** the debt to the present. The lender gives the debtor a **notice of foreclosure** or **notice of default** demanding that the debtor pay the entire **outstanding balance** of the loan at once. The notice of foreclosure is recorded in the county where the property is located, giving **constructive notice** of pending court action (lis pendens).

Some states allow a **statutory right of reinstatement**, which is a way for borrowers to **cure the default by bringing the mortgage current**—including all accumulated costs and fees—within a specified timeframe after they receive a notice of foreclosure or after the notice was recorded. The lender generally cannot proceed with the foreclosure action until the reinstatement timeframe has passed.

Judicial Foreclosure Action

If the debtor fails to satisfy the debt within the timeframe stated in the notice of foreclosure, the lender files a lawsuit, called a **foreclosure action**, in a court of jurisdiction where the property is located. The court will determine whether the lender is rightfully owed the money and the debtor is in default. If the court finds in favor of the lender, the judge will issue a **summary judgment of foreclosure**, after which a **foreclosure sale** may be scheduled, assuming any statutory redemption period has passed.

Some states allow debtors to redeem (save) the property from foreclosure from the time a notice of foreclosure is filed until the foreclosure sale takes place and/or the court has ratified the sale. This is done by paying the amount that is in default, as well as applicable court costs and attorneys’ fees. This right to redeem the property **prior to the sale** is called the **equitable right of redemption**. A foreclosure sale may not take place until the timeframe for redemption has passed.

Judicial Foreclosure Sale

The public is notified of the place and date of the sale via advertising that runs for a specified number of weeks in a newspaper circulated in the county. On the sale date, a **public auction**, sometimes called a **sheriff’s sale** or a **judgment sale**, is held where anyone can bid on the property. The minimum bid is generally a set percentage of the appraised value, and it **must be a cash transaction**.

The property is sold to the highest bidder, and a document called a **certificate of purchase** is filed to finalize the sale. The officer of the court makes out a **sheriff’s deed** to the purchaser of the property once the sale is confirmed. This deed—which does not include any warranties—is executed, acknowledged, and recorded like any other deed.

Some states allow what is called a **statutory right of redemption** through which debtors may redeem the property for a period of time **after the foreclosure sale**. Once the redemption is made, the court will set aside the sale, pay the parties, and the debtor regains title to the property.
Nonjudicial Foreclosure

When a trust deed is used as a security instrument, title to real property goes into a trust until the debt is repaid. The lender is the beneficiary and the borrower is the trustor. A disinterested third party is the trustee. A distinguishing characteristic of trust deeds is that the trustee may begin a nonjudicial foreclosure action (sometimes referred to as non-statutory foreclosure) when the debtor defaults on the note or trust deed. This nonjudicial action is authorized by a power of sale clause in the trust deed. The trustee has the authority to sell the property after proper notice to the defaulting borrower without the time and expense involved in court proceedings. The buyer receives a trustee’s deed.

While there is generally no right of redemption, the borrower may have the right to stop the sale and reinstate the loan by making back payments (plus interest, trustee’s fees, and attorneys’ fees).

Foreclosure can also be the outcome when any creditor or other plaintiff wins a judgment in court over a defendant who is unable or unwilling to pay the amount ordered by the court. The court will issue a writ of execution, which authorizes the sheriff or other legal official to take possession of the defendant’s property. The property can then be sold so that the plaintiff can collect on the court-ordered judgment.

Proceeds from Foreclosure Sale

Proceeds from a foreclosure sale are used to first pay reasonable expenses associated with the sale and then to pay off the mortgage(s) and any other liens, generally in the order in which they were filed:

- Ad valorem property taxes are always paid first.
- After taxes are paid, any costs associated with the foreclosure proceedings are paid, such as fees for the sheriff, appraisers, transfer tax, auctioneer, etc.
- Then the first lien (usually the senior mortgage) is paid in its entirety.
- If any money remains, the second lien (such as a junior mortgage or judgment lien) is paid.
- Then, the third lien is paid, and so on, until all the money has been disbursed.

Any overages (surplus) remaining after all debts, liens, expenses, and costs related to the property are paid may go to the debtor.

Deficiency Judgment

If the sale of the collateral property through foreclosure sale does not raise enough to cover the entire loan amount, accrued interest, and other costs, the creditor may be able to obtain a deficiency judgment against the property owner. This is a court-ordered personal judgment against the debtor that creates a general, involuntary lien against all real and personal property.

Some promissory notes are written to protect the borrower from such a lien. An exculpatory clause in a note limits the lender’s rights in a foreclosure to the amount received from the sale of the foreclosed property.
If the balance of the promissory note has not been paid in full from the proceeds of the sale, the lender cannot obtain a deficiency judgment for the unsatisfied amount. This is referred to as non-recourse financing since the lender “has no recourse” against the borrower for the unsatisfied portion of the loan. This is more common in a deed of trust.

**Real Estate Owned (REO)**

If the property does not sell at the public auction, the lender legally repossesses the property and it goes on their books as a real estate owned (REO) asset. REO property is held in inventory and may be sold to recoup all or part of the lender's investment. As lenders generally do not want to hold REO property, they will try to sell it to the public as soon as possible, either by auction or real estate brokers. Some lenders have a special asset management department that handles the process. Some asset managers manage as many as 500 properties at one time.

A licensee tasked with listing REO property for sale will likely find that bank-owned properties have more inherent challenges than traditional owner-occupied listings.

The condition of foreclosed properties can vary significantly:
- Vacated houses are often vandalized—being stripped of all salvageable materials like copper piping, metal, wire, light fixtures, and bathroom fixtures. Many houses require substantial repairs just to be in livable condition.
- The house can be exposed to weather conditions and vermin. With conditions like rain, snow, cold, and humidity, the house is susceptible to mold and rot. In some cases, by the time the properties can be sold, they are depreciated to a point that no one wants to buy them.
- Occasionally an occupant becomes hostile and causes significant damage to the property before leaving the premises.

**Alternatives to Foreclosure**

Foreclosure is usually the option of last resort. Many lenders prefer to find other alternatives.

- **Deed in Lieu of Foreclosure.** A homeowner voluntarily conveys ownership of the property to the lender by signing over the deed, after which the property can then be sold to recoup all or part of the lender's losses.
- **Loan Modification.** The lender agrees to modify the loan terms by reducing the monthly payment amounts or interest rate, extending the term of the loan, or some other agreed-upon change.
- **Repayment Plan.** The lender and the homeowner reach an agreement in which an additional predetermined amount is added to the mortgage payment for several months until the delinquent amount is paid in full, bringing the account current. Borrowers can then focus on rebuilding their credit while remaining in the home.
- **Forbearance Agreement.** The lender agrees to temporarily reduce, postpone, or suspend the mortgage payment and not proceed with foreclosure if the borrower brings the loan current within the specified time.
- **Refinancing the Home.** A homeowner may be able to refinance the mortgage loan at a lower interest rate or extend the loan over a longer period of time. To refinance, there must be adequate equity in the home and the homeowner must have a good credit score.
- **Renting the Home.** A homeowner who can find alternate housing may consider renting the home until the financial situation improves or the real estate market recovers. There are, obviously, many responsibilities that go along with being a landlord, so it is not the right solution for everyone.
- **Selling the Home.** A homeowner can proceed with a home sale if the homeowner can cash in assets or borrow money to pay off the mortgage note, pay the real estate commission, and pay closing costs. If the homeowner cannot afford to pay off the mortgage loan and other costs, a typical home sale is not an option.

- **Mortgage Assumption.** A buyer assumes the current loan at the original loan interest rate. To assume the loan, the buyer must apply for a new loan and be approved by the lender. Most conventional lenders do not permit loan assumptions. FHA and VA lenders allow loan assumptions with proper approval and release.

- **Bankruptcy.** A homeowner may consider filing for bankruptcy; however, it negatively affects the credit score more than any other alternative.

### Short Sale

If none of the options to stay in the home are viable, a **short sale** may be a preferable alternative to foreclosure. With a **short sale**, or short payoff, *the lender agrees to accept less than the loan balance when real property is sold*. Actually, “short sale” is a bit of a misnomer, as the process takes **much longer** than a typical home purchase.

If a short sale is the best option, the homeowner must work with the lender's **loss mitigation department**. To qualify for a short sale, the seller must prove to the lender that he is suffering financial hardship. This is typically done with a **hardship letter** in which the seller documents the specific reasons for the hardship, along with supporting evidence. The goal is to **convince the lender to approve the short sale**.

A **letter of authorization** from the seller to the lender is required in order for the seller's agent or representative to contact the lender on the seller's behalf.

### Short Sale Package

Once the seller has an offer from a qualified buyer, a **short sale package** can be submitted to the lender's loss mitigation department. In most cases, the listing agent coordinates this. The loss mitigator will review the short sale package and, if it is complete, determine the best plan of action to remedy the borrower's situation with the least amount of loss to the lender. A short sale package generally includes:

- Cover letter summarizing the seller's hardship situation, amount owed on the home, the offer, and the amount the lender can expect to net from the sale
- Hardship letter with supporting documentation
- Employment pay documentation from the past two months
- Bank statements from the past two months
- Income tax returns from the past two years (including W-2s and/or 1099s)
- Financial statements and monthly budget
- Comparative market analysis (CMA)
- Preliminary settlement statement showing zero profit to the seller
- Report of any property damage or needed repairs, including photos and cost estimates
- Market conditions and history reports
- Listing agreement
- Purchase contract
- Written proof of the buyer's ability to purchase
- Short sale application
Rejecting a Short Sale

There are several viable reasons why the lender may reject a short sale:

- **Seller does not qualify.** A seller would likely be ineligible if the hardship is due to careless money management or if the settlement statement shows a profit for the seller.

- **Buyer does not qualify.** A buyer who cannot provide a loan pre-approval letter may end up not being qualified when the loss mitigator checks the loan approval status.

- **Offer price is too low.** If the offer price is lower than the appraised value of the property, the lender may reject the offer in hopes of obtaining a higher offer or selling price through foreclosure. The loss mitigator is not likely to reveal the price that’s acceptable so as to get the highest possible offer.

- **Lender sold the loan.** If the lender is simply servicing the loan and does not own the loan, it does not have the authority to approve the sale.

One of the most frustrating aspects of a short sale is the **time it takes to close;** months of waiting is not unusual. Every stakeholder—the lender, loan servicer, lienholders, mortgage insurers, securities investors, and possibly others—must decide whether to approve the short sale. Offers often expire before the lender responds.

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**Tax Considerations**

If the terms of a mortgage hold a borrower personally liable for the whole amount of the loan, any debt that the lender cancels through a short sale or foreclosure could be taxable as income.

While that is not generally the case under the provisions of the federal Mortgage Forgiveness Debt Relief Act of 2007, lenders will still report any debt cancellation on Internal Revenue Service form 1099-C.

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**Summary**

1. **Borrowers can be pre-qualified or pre-approved.** **Prequalification** allows an MLO or lender to review a borrower's history to determine if they're likely to get approved for a loan, and the approximate amount. Prequalification is not binding. With **preapproval,** a lender evaluates an application and indicates the borrower can be financed for a specific amount. Only a lender can preapprove a borrower.

2. **Points** are 1% of the loan amount; they increase the lender's yield and are paid for many reasons. **Discount points** are used to buy down the interest rate. One discount point equates to 1/8 of a percentage point. Lenders generally require borrowers to have property insurance (and flood insurance if necessary). A **budget mortgage** combines principal, interest, ad valorem property taxes, and property insurance premiums (PITI). The monthly payments for insurance and taxes are held in an **escrow account** so the lender can ensure payment.

3. A borrower's monthly **income** must show stability, quality, and durability. Bonuses, commission, part-time earnings, and overtime all count if shown to be a consistent part of the borrower's income for the past few years. Lenders do not usually count temporary unemployment and other occasional income. **Credit history** is a record of debt repayment. **Credit scoring** is an objective means of evaluating credit. Lenders verify assets and may require financial statements.
4. The **Truth in Lending Act (TILA)**, implemented by **Regulation Z**, requires lenders to make specific disclosures. The **annual percentage rate (APR)** is the total cost of financing, including the interest rate and all fees. The right to rescind extends to three days after closing, but applies only to home equity loans, refinances, etc. Ads with triggering finance terms must disclose down payment, loan terms, and annual percentage rate (APR). The **Real Estate Settlement Procedures Act (RESPA)** requires disclosure of estimated closing costs. Lenders must give borrowers the Loan Estimate disclosure, as defined by the TILA-RESPA Integrated Disclosure (TRID) Rule, within three business days following the date of a completed mortgage loan application. The **Equal Credit Opportunity Act** prohibits discrimination in granting credit to people based on sex, age (if at least 18), marital status, race, color, religion, national origin, receipt of public assistance, or exercised rights under the Consumer Credit Protection Act.

5. **Conventional loans** are not insured or guaranteed by a government agency. Traditional conventional loans are long-term, fully amortized, and have a fixed rate. Conventional loans may be for 15 or 30 years, conforming or nonconforming. A 15-year loan retires sooner and saves interest, but requires higher payments. **Private mortgage insurance (PMI)** insures lenders against borrower default, compensating lenders for the event of a loss of collateral value in the event of default. An 80% conventional loan means the **loan-to-value ratio (LTV)** is 80% of the appraised value or sale price of property, whichever is less. Qualifying standards for conforming loans are 28% housing expense and 36% debt-to-income.

6. **FHA-insured loans** are for owner-occupied single family and multi-family dwellings of four or fewer units, made by approved lenders and insured by the Federal Housing Administration. FHA loans require lower down payments and less stringent qualifying standards than conventional loans. The FHA sets a maximum mortgage amount, depending on the geographic area. Qualifying ratios are 31% housing expense and 43% debt-to-income. FHA loans require a minimum 3.5% down payment.

7. **VA-guaranteed loans** help eligible veterans buy homes often with no down payment. The veteran must occupy the home. The VA doesn’t limit the home price, but it does limit the guaranty amount that the lender can recover for default to 25% of the maximum loan limit in the county where the property is located. The debt-to-income ratio is 41%. VA loans also consider residual income.

8. **Rural Development** is an agency under the **U.S. Department of Agriculture** that offers various assistance programs for both businesses and homebuyers in rural communities, which can include small towns and areas hit by natural disasters.

9. **Judicial foreclosure** is a court action that a lender or creditor initiates to foreclose on a mortgage or other debt. The property is sold at a sheriff’s sale of the property to repay the debt. **Nonjudicial foreclosure** occurs when a trustee under a power of sale clause in a deed of trust sells the property on behalf of the lender (beneficiary) without the involvement of a court (not used in all states). As an alternative to foreclosure, a lender may agree to accept less than the value of a property, known as a **short sale**. This requires the approval of all stakeholders and can be very time-consuming.
Chapter Quiz

1. What is an important distinction between prequalification and preapproval?
   A. Prequalification always requires an application fee.
   B. Prequalification of a buyer is not binding on the lender.
   C. Prequalification of a buyer is not useful to a real estate licensee.
   D. Prequalification requires the lender to pull a credit report.

2. The purpose of requiring payment into a mortgage escrow account is to
   A. allow the borrower to obtain actual cash from the equity built up in the property.
   B. allow the lender to participate in any earnings, income, or profits generated.
   C. ensure that enough funds are collected to cover taxes and insurance premiums.
   D. include the financing of personal property, such as appliances or furnishings.

3. J buys a house for $150,000, making a $30,000 down payment and paying three discount points to bring down the interest rate. What is the total cost of the discount points?
   A. $1,500
   B. $3,000
   C. $3,600
   D. $4,500

4. A lender must deliver the Loan Estimate to a borrower within ________ of submitting a completed loan application.
   A. 2 business days
   B. 3 business days
   C. 5 business days
   D. 7 business days

5. Which property would NOT be subject to the disclosure requirements of RESPA?
   A. a condominium unit in a high-rise building
   B. a farmhouse on a 10-acre lot
   C. a four-unit apartment building
   D. a single-family home bought with cash

6. Which agency has enforcement oversight of the Truth in Lending Act and the Real Estate Settlement Procedures Act?
   A. Consumer Financial Protection Bureau
   B. Department of Housing and Urban Development
   C. Department of Justice
   D. Federal Housing Administration

7. How many days after a prospective borrower submits a completed loan application must the lender render a credit decision?
   A. 15 days
   B. 20 days
   C. 30 days
   D. 45 days

8. Regulation Z implements what federal lending law?
   A. CRA
   B. ECOA
   C. RESPA
   D. TILA

9. What is the soonest a mortgage loan could theoretically close?
   A. 3 business days after the application is submitted
   B. 3 business days after the required disclosures are delivered
   C. 7 business days after the required disclosures are delivered
   D. 10 days from when the applicant states an intention to proceed with the loan

10. A borrower buys a house for $160,000. He gets a loan for $140,000 and makes a $20,000 down payment. What is LEAST LIKELY to be an acceptable source of funds for his down payment?
    A. borrowed funds
    B. a gift from a relative
    C. proceeds from the sale of a house
    D. savings
11. When evaluating a loan applicant’s credit obligations, which would LEAST LIKELY be considered as debt?
   A. cable television premium channel fees
   B. car loan payment with 15 payments left
   C. child support payments
   D. credit card debt payments

12. As a lender’s underwriters evaluate a borrower’s loan application to decide whether to make the loan, they may NOT consider the borrower’s
   A. employment history.
   B. field of employment and its economic viability.
   C. history of making payments on past obligations.
   D. receipt of public assistance.

13. A borrower’s stable monthly income is $3,000. He has three monthly debts: $350 car payment, $50 personal loan payment, and $50 credit card payment. What is the maximum monthly mortgage payment he would qualify for on a conventional loan?
   A. $390
   B. $630
   C. $840
   D. $1,080

14. The asking price of a house is $235,000. A prospective buyer offers $230,000, and the house appraises for $225,000. If the lender is willing to make an 80% LTV loan, what is the required down payment if the offer is accepted?
   A. $45,000
   B. $46,000
   C. $47,000
   D. $50,000

15. Private mortgage insurance is automatically canceled when the loan has been paid down to _____ or less of the property’s current value.
   A. 72%
   B. 75%
   C. 78%
   D. 80%

16. A buyer is paying $200,000 for a house. He makes a $30,000 down payment, gets a first mortgage for $160,000, and a second mortgage to cover the balance. What is his CLTV?
   A. 80%
   B. 85%
   C. 90%
   D. 95%

17. A prospective buyer makes an offer of $105,000 on a house that was appraised for $112,000. If the seller accepts his offer, what is the minimum down payment the buyer must make to get an FHA-insured loan?
   A. $3,675
   B. $3,920
   C. $5,250
   D. $5,600

18. To establish the value of a property for a VA-guaranteed loan, a lender must obtain what document?
   A. appraisal
   B. certificate of eligibility
   C. certificate of reasonable value
   D. DD-214

19. Which sequence of events BEST represents the steps in a judicial foreclosure?
   A. foreclosure action; equitable table redemption period; notice of foreclosure; sheriff’s sale; reinstatement period
   B. foreclosure action; notice of foreclosure; reinstatement period; sheriff’s sale; equitable redemption period
   C. notice of foreclosure; foreclosure action; reinstatement period; sheriff’s sale; equitable redemption period
   D. notice of foreclosure; reinstatement period; foreclosure action; equitable redemption period; sheriff’s sale

20. A homeowner wants to avoid foreclosure and asks the lender to accept a purchase price that is less than the amount owed on the property. This type of arrangement is a
   A. deed in lieu of foreclosure.
   B. deficiency agreement.
   C. forbearance agreement.
   D. short sale.
While you may not perform a formal appraisal without a proper appraiser’s license, real estate licensees need to have a general knowledge of how property may be valued. This chapter considers how real estate prices are affected by the market with a focus on factors that influence the value of a specific property. It examines various principles that impact value and introduces the formal steps in the appraisal process. We’ll also spend time discussing a valuation technique that you, as a real estate licensee, will perform—a comparative market analysis.

After reading this chapter, you will be able to:

- List the steps in the appraisal process.
- Identify key principles related to value.
- Discuss how a comparative market analysis and a seller’s required net impact the asking price of a property.

Key Terms

Anticipation  
Appraisal  
Arm’s Length Transaction  
Assemblage  
Broker Price Opinion (BPO)  
Comparative Market Analysis (CMA)  
Comparables  
Conformity  
Contribution  
Cost  
Days on Market (DOM)  
Highest and Best Use  
Market Value  
Neighborhood  
Net to Seller  
Plottage  
Price  
Progression  
Reconciliation  
Regression  
Situs  
Substitution  
Uniform Standards of Professional Appraisal Practice (USPAP)  
Uniqueness
What is an Appraisal?

An appraisal is an estimate or opinion of value as of a certain date that is supported by objective data. There are many concepts in that short definition. First, it's important to realize that appraisal is only an estimate or opinion. It is not a guarantee of value. It's also important that the estimate or opinion of value be supportable and based on facts—even though there’s some room for interpretation of the facts. Good appraisers know where to obtain these facts and data, and how to interpret their effect on property value.

The other equally important part of the definition of appraisal is that the estimate of value is as of a certain date. Because change is constantly occurring, factors that influence real estate, or property-specific factors, do not remain constant. This is why an appraisal is only valid as of its effective date. The effective date of the appraisal establishes the terms, conditions and economic circumstances upon which the value is estimated.

It’s just as important to know what an appraisal is NOT. An appraisal is not a:

- Guarantee of value.
- Prediction of future worth.
- Determination of what someone will pay for a piece of real estate.
- Inspection of the property.
- Guarantee that the house is free of defects.

Uses for Appraisals

The most common reason an appraisal is performed is for lenders and mortgage companies to determine the value of property used as collateral for mortgages or investments. Appraisals may be performed for a variety of other reasons, such as to determine property values for the following:

- Sellers wanting an appropriate listing price
- Purchasers wanting to confirm an appropriate offer price
- Civil lawsuits
- Divorces
- Bankruptcies
- Estates and trusts
- Eminent domain valuations
- Insurance coverage or claims
- Tax matters
- Determination of construction or remodeling costs

The Appraisal Profession

Appraisal as a discipline and a profession has its origin in the 1930s. People had always made their own estimates of value when making a buying, selling, or lending decision regarding real estate. But in the 1930s, as lenders began to make more and more mortgage loans, it became necessary to create a standardized process to determine value so lenders could make consistent and informed decisions.
To meet the needs of lenders, the American Institute of Real Estate Appraisers formed in 1932, and the Society of Residential Appraisers formed in 1935. These two organizations were merged in 1990 to create the Appraisal Institute.

The Federal Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), passed in 1989 as a comprehensive savings and loan bailout, also addressed the need for standardization in the appraisal industry. Although certification or licensing is voluntary in most states, the individuals and entities that hire appraisers generally require that the appraiser be state licensed or certified.

- **Licensed Residential Appraisers**—May appraise residential land, single-family homes, and 2- to 4-unit residential properties valued up to $1 million that are non-complex in nature. May also appraise residential land or single-family or 2- to 4-unit residential properties with a transaction value of up to $250,000 that are complex in nature.

- **Certified Residential Appraisers**—Have no limit on value or complexity of land, single-family homes, or 2- to 4-unit residential properties they may appraise.

- **Certified General Appraisers**—May appraise any type of property (e.g., residential, investment, commercial) with no limits on value.

Recognizing the profession’s impact on the mortgage market, FIRREA requires that all appraisals in excess of $250,000 for use in connection with any federally related transaction be performed only by real estate appraisers who are licensed or certified by the state in which the real estate is located.

Appraisers need a good understanding of real estate and each appraisal approach, as well as the education and experience necessary to carry out assignments. The Appraisal Foundation, a private, nonprofit educational corporation, is the parent organization of the Appraiser Qualifications Board (AQB), which exercises authority over the establishment of education, experience, and other criteria for licensing, certification, and recertification of appraisers. The requirements to become a licensed or certified appraiser are quite rigorous.

**Uniform Standards of Professional Appraisal Practice (USPAP)**

The Uniform Standards of Professional Appraisal Practice (USPAP), established and promoted by the Appraisal Standards Board of the Appraisal Foundation, dictates a number of standards, rules, and guidelines that licensed and certified appraisers must follow when completing an appraisal report.

Many of these rules relate directly to the appraisal report itself. For example, whenever an appraiser undertakes an assignment to develop an opinion of value, it is unethical for the appraiser to accept compensation contingent upon the reporting of a predetermined value or even a direction in value that favors the client. Any interest the appraiser may have in the subject property or the outcome of the appraisal must be clearly documented in the appraisal report.
The Appraisal Process

Appraisers apply their knowledge and specialized skills in solving valuation problems by following a recognized and distinct method known as the appraisal process. By using the same logical progression of analysis in a thorough, comprehensive, and accurate manner, appraisals become a valuable tool lenders and others can rely on when making assessments and decisions about a specific property.
**Step 1: Problem Definition**

Defining the problem consists of identifying the elements of the assignment. In this step, the appraiser determines:

- The **client** and any **intended users** of the property that the client identifies
- The **intended use** of the property
- The **purpose** of the appraisal, including the type of appraisal and definition of value
- The **effective date**, or date of the value opinion, which establishes the context for the opinion of value
- Any relevant property characteristics, e.g., location, type of property, ownership interest to be appraised
- Other assignment conditions, e.g., the appraiser is required to make certain assumptions or apply hypothetical conditions

**Step 2: Scope of Work**

After the appraiser properly considers all information obtained during problem identification, the next step in the process is to determine the **scope of work**. It may be helpful to think of the scope of work as an appraisal plan—an outline identifying the work needed to complete the appraisal. The plan can be used as a guide for all who will participate in the appraisal, as well as a basis for the appraiser to establish an appropriate fee for the assignment. The decisions made here must lead to credible assignment results. In other words, the scope of work determination must be logical and reliable for the intended user and intended use of the property, and it will depend greatly on the relevant property characteristics.

**Step 3: Data Analysis**

This step includes an analysis of the **subject property** as well as a **market analysis**, which examines the relationship between supply and demand, the economic base, the neighborhood, the competition, and many other value characteristics. This is important since the value opinion developed for a property truly reflects the marketplace.

**HIGHEST AND BEST USE** A critical element of data analysis is the determination of the property’s **highest and best use**, which represents the greatest economic advantage to the owner. The first step that an appraiser takes when determining highest and best use is to **estimate the value of land as if it were vacant and available for any permitted use**. Then, the highest and best use analysis has four tests as it seeks to define what is:

- Legally permissible
- Physically possible
- Financially feasible
- Maximally productive

The goal of defining highest and best use is to determine whether the property is being used for its **most profitable** permitted use. While not as important for homes located in the middle of residential neighborhoods, highest and best use becomes a vital consideration when examining vacant land or land that has changed zoning since the original structure on it was built.
Step 4: Application of Approaches

Appraisers value properties using three different approaches. Each approach is independent of the others and performed separately to arrive at an opinion of value. Many factors can drive the appraiser's choice in the application of the approaches, such as the type of property being appraised and the type and extent of analysis needed in an assignment. As a result, the appraiser could elect to use one, two, or all three of these approaches as necessary to develop a credible opinion of value:

- The **sales comparison approach** is most relied upon when there is recent sales data in the subject property's area; it is the most common appraisal approach for residential property.
- The **cost approach** is most relied upon for properties with new or almost new improvements, or for unique properties.
- The **income approach** (also called the **capitalization approach**) is most relied upon in appraising investment properties when income data for comparable properties are available.

Step 5: Reconciliation

Opinions of value from all fully developed approaches are **reconciled** to arrive at the best estimate of value. Rarely, if ever, are the value estimates from these three approaches equal, and they are never merely averaged. This is where the appraiser's knowledge and experience are invaluable. Reconciliation involves giving each method an **appropriate weight** depending on the type of property being analyzed, and the amount and accuracy of data available.

For example, if the appraisal is for a single-family home, then the appraiser would give the most weight to the sales comparison approach. This is not only because it would provide the most recent information, but also because the appraiser knows that that approach typically provides the most reliable information and the most accurate indicator of the property's market value. If the appraisal were for an income-producing property, then the appraiser would give the most weight to the income approach, and so on.

Step 6: Report Findings

The final step of the valuation process is to prepare and submit a report of the conclusions from all data gathered and analyzed. The report should include all data, including specific references to support the appraiser's conclusions and a final value estimate for the subject property. Although the Uniform Standards of Professional Appraisal Practice (USPAP) allows oral reports under certain conditions, usually the appraiser communicates his results in a written report.

The **Uniform Residential Appraisal Report (URAR)** form is a standard appraisal report form used by lenders and appraisers because it has been developed and approved by secondary mortgage market players Fannie Mae and Freddie Mac. As the name implies, it is used for residential appraisals and is preferred by lenders because it is standardized, allowing residential properties to be compared in a consistent manner.
Principles of Value

There is a wide variety of factors and principles that can impact the value of real property. You may recall P-E-G-S from an earlier module, which refers to four broad categories of forces that influence the real estate market: Physical, Economic, Governmental, and Social. These all play different, but important, roles in the value of land in general and in a specific property. A good appraiser is aware of these factors and how to weigh them when subjective criteria must be applied to a given factor in an overall appraisal.

Value

Value is the present worth of the future benefits of ownership of a commodity. Value, you'll recall, is rendered as an opinion. The value of a piece of real estate should never be confused with its price or cost.

Most residential appraisals are used to render an opinion of the market value of property. Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale. Recent marketplace activity is the best objective evidence of what a typical buyer would do or pay. This value conclusion is the most frequently specified in an appraisal and, therefore, is likely to be the most common type of value used in typical real estate transactions in which real estate brokers take part.

Price and Cost

Although at times the term “value” seems to be synonymous with “price,” these two words actually have very different meanings. A property’s price can generally be defined as the amount someone actually paid for a property. Price is a fact. In theory, the market value and price should be similar, but that is not always the case. For example, an appraiser assigns the value opinion of $230,000 to a property, and the seller might accept $220,000 as the sales price. Of course, both value and price may have nothing to do with cost. Cost is the amount needed to develop, produce, or build something. Cost may be a fact or an estimate. Based on this definition, it is easy to see how the value and price of the property may not correspond with its cost. Depending on many factors, such as the economic climate, real estate market, and the seller’s situation, a property could, in fact, sell for less than its cost to develop, build, and maintain.

Arm’s Length Transaction

The definition of market value talks about a “competitive and open market.” This assumes that property is part of a typical “arm’s length” transaction. An arm’s length transaction is a transaction that occurred under typical conditions in the marketplace with each party acting in his own best interest. Those typical conditions include the following:

1. The buyer paid cash for the property at closing or obtained a conventional mortgage through a lender so as to pay the seller the agreed-upon price at closing.
2. The seller did not grant any unusual payment concessions, such as owner financing or other payment terms.
3. The buyer and seller are not related in any way.
4. The buyer and seller are both acting in their own best interests.
5. The buyer and seller are not acting out of undue haste or duress.

6. The buyer and seller are both reasonably informed about all aspects of the property, its potential uses, market value, and market conditions; or the buyer and seller can hire professional representatives such as attorneys and appraisers to assist with this.

7. The property has been available on the market for a reasonable period of time.

All of these factors should be considered when evaluating comparable properties.

Other Types of Value
Additional types of value that real estate professionals should understand include the following:

- **Mortgage or Loan Value.** The amount of money a lender is willing to let someone borrow to finance, or refinance, property. Usually, this figure is a percentage of the appraised value or the sales price, whichever is lower (loan-to-value ratio or LTV).

- **Investment Value.** The highest price investors would pay for a property based on how well they believe it will serve their financial goals.

- **Insurable Value.** The amount a property can be insured for, usually representing only the replacement cost of the structure and disregarding any value for the land.

- **Assessed Value.** The amount used to calculate property taxes due, sometimes representing a percentage of the market value.

- **Value in Use.** The present value to an owner of property that has a specialized use; also called utility value.

- **Liquidation Value.** The value a property could get if sold under the duress of a must-sell situation with less than typical market exposure.

Characteristics of Value
Before anything can have value, certain value characteristics must be present and perceived by the user and other potential users of the property. All four characteristics must be present and in harmony for the item to achieve maximum value (remember D-U-S-T):

- **Demand**
- **Utility**
- **Scarcity**
- **Transferability**

**Demand**

*Demand* is the need or desire for a specific good or service and is an essential ingredient in creating value. Without demand, any amount of supply is meaningless. But, when you have purchasers who want what you have to sell, you command value. Everyone needs a place to live; however, some people want more than a basic rentable space—they want to own real estate. That is where desire enters the picture. Determining what someone really wants (and can afford) versus what they need is critical to finding the best property to purchase. A homebuyer, typically, wants to satisfy basic needs or individual wants beyond life’s essentials. And, when you have something people desire, you are able to maximize value even more.

Along with demand, effective demand must also be present to create value. **Effective demand** (or purchase ability) means the prospective buyer has enough disposable income available to satisfy her needs or desires. A person may want a million-dollar home, but if she cannot afford to buy it, then that person’s “demand” does not apply.
Utility

Utility is the ability of a good or service to satisfy human wants, needs, or desires. Utility is the degree of usefulness to a prospective buyer. There can be demand for housing, but your sellers' homes must be perceived as useful (i.e., enough bedrooms) to someone interested in buying it. A majority of typical buyers must have the same perception of utility for a property to have value in the marketplace. If there is no perceived use for something, there is no perceived value.

Scarcity

Scarcity is the perceived supply of a good or service relative to the demand for it. If there is an unlimited supply of something, it is perceived to have little value. Of course, the scarce item must also be useful (have utility). Things that are scarce but not useful have little value (e.g., a four-car garage attached to a one-bedroom home), just as things that are useful but plentiful have little monetary value (e.g., air and water). People generally perceive real estate to be a valuable commodity because there is a limited supply of it. This notion drives the anticipation that buying a home is an investment that will increase in value as time goes by.

Transferability

Transferability is the ability to freely buy, sell, encumber, or dispose of property in any way the owner sees fit. The fewer the restrictions on the property, the greater the perceived value. If there are conditions on title to land, which restrict its future transfer, a buyer would likely not pay as much for it (provided ready substitutes exist in the market). Public and private restrictions are a factor. Any restrictions imposed on transferability may decrease the perceived value to potential buyers.

Physical Characteristics

Real estate has three physical characteristics that serve to give land inherent value.

- Uniqueness
- Immobility
- Indestructibility

These unique characteristics are not present as a group in personal property. Only real estate has this combination of physical attributes and, as a result, appraisers must understand how they can affect value. Note how the three physical characteristics of real estate are often intertwined with the four value characteristics.

Uniqueness

Uniqueness, also known as non-homogeneity, goes to the very heart of real estate ownership itself, as each piece of land and each structure are said to be a different piece of real estate. Even if two houses look the same, they are still held to be unique because of their particular locations. As a value consideration, however, uniqueness can be good or bad. A unique feature of a property could make it less desirable and hurt its value if it's something other people do not want. Of course, a unique feature that adds character can make it more desirable and add to its value.

Since no more land can be created in any given location, this uniqueness leads buyers to view land as a scarce commodity. When people want to build in a certain area, they must compete with others for the limited supply of land. Value is derived from this perceived scarcity due to uniqueness.
Immobility

Immobility is a physical characteristic of real estate referring to the fact that the real estate itself cannot move from one place to another. The immobility of land helps its value in a good market since other land can’t be moved in to take away potential customers. Immobility hurts its value in a bad market as it can’t be relocated to a better position to attract buyers. The immobility of customers means they can’t easily move to take advantage of real estate in other cities, and demographic patterns show that most people stay within a given region.

Indestructibility

Indestructibility refers to the fact that real estate cannot be destroyed. Even though events like tornadoes and earthquakes can physically change a property and its improvements, ownership interests are far broader. Thus, real estate will always have some value by virtue of its mere existence. Land is not consumed, nor does it wear out like other goods. But the marketplace or other forces can affect the actual and perceived utility of land. Land always has the potential to be useful, but its usefulness—and its value—can change over time.

Property-Specific Factors

Highest and best use, discussed earlier, is a critical factor when determining the value of a specific piece of property, but there are other property-specific factors that an appraiser may consider before making a determination of value.

Location

Location is the exact position of a piece of real estate, also known as its situs. This is particularly important when considering the value of real property. Location can be talked about with respect to a given neighborhood, which is any contiguous area that may be identified by similar characteristics or physical boundaries. Natural boundaries include obvious boundaries, such as rivers and lakes, but they also include less obvious ones, such as parks, mountains, and valleys. Artificial boundaries include man-made dividing lines such as streets, highways, and railroads; government officials may draw neighborhood boundaries along school, zoning, or political districts.

Neighborhoods can also be defined by other characteristics. Properties that have similar uses or zoning, price ranges or income levels, or properties that share shopping, social, civic, or recreational facilities, may all be considered part of the same neighborhood. In fact, almost anything can define a neighborhood except for race, ethnicity, or any other characteristic that describes a protected class. A neighborhood is simply a small part of a larger community.

Personal inspection allows an appraiser to see if there are perceptible changes in neighborhood characteristics at any of the physical boundaries defined. During this personal inspection, the appraiser is also looking for similarity of land usage and types of improvements, as well as consistency of building style and landscaping; even maintenance or upkeep can be evaluated as a means of confirming neighborhood boundaries.
Even within a single neighborhood, a property's location is important. For example, there are two lots of identical size with relatively identical houses. One parcel is on the west side of Bay Street, and the other is across the street. The parcel on the east side of the street backs up to the bay. Since it's located on the water, it will likely have greater value. Less dramatic but still significant, consider identical lots with identical houses in a subdivision. Corner lots and lots on a cul de sac tend to have greater value.

**Progression**

An important corollary to the concept of location is the effect of surrounding properties on valuation. The theory goes that the value of the “worst” property in a given area is brought up by the other properties in the area. The value of a property that is run-down can benefit from being in a good area among other properties that are well-kept. The value of this theoretical “worst” property can only go so low because the desirability of the other properties in the neighborhood will keep it from falling too far. People will pay more for the rundown property, anticipating that they can recoup their investment by fixing it up.

When the value of a property is helped up by the other properties in an area, it is known as progression.

**Regression**

Conversely, the value of the “best” property in a given area is held down by the other properties in the area. The value of an upscale property in an average area can be hurt by the fact that people may not want to pay too much for a property that's not surrounded by comparably priced properties, and they may fear a lower resale value. It is generally considered risky to have the best house in the neighborhood.

The value of this theoretical “best” property can only go so high because people who can afford this “best” property will be attracted to other neighborhoods.

When the value of a property is held down by the other properties in an area, it is known as regression.

**Substitution**

Substitution says that an informed buyer will not pay more for a home than a comparable substitute. Although each home is said to be unique, there's a price point beyond which a buyer won't select a particular home. Of course, no one really knows what that point is until they are trying to sell a home for too much, with no resulting sale.

The theory of substitution can also be applied to items within a home. When an appraiser determines the value of a fireplace in an area where most homes don't have one, the appraiser must take into account that a buyer is not going to pay more for that home than for a similar home plus the cost of adding a fireplace. In other words, if a fireplace costs $2,500 to add to a typical home in the area, an appraiser can't justify adding much more than that to the value of a home due to a fireplace.
**Conformity**

Conformity says that a particular home achieves its maximum value when surrounded by homes of similar style and function. This applies to neighborhoods as well. Neighborhoods as a whole are more desirable when there is a general similarity in utility and value for all homes in it. This relates to our best/worst home scenario. Most people want to live in areas with like homes. A home that stands out as being too different from the rest is worth less than that same home would be if it were in a more homogeneous neighborhood. If too many homes stand out as different, the neighborhood’s desirability is hurt as well.

**Anticipation**

When a future benefit or event may affect a particular parcel of land, its value may increase or decrease based simply on the anticipation of that benefit or event. For example, if the owner of a farm sells the property to a developer who proposes a golf course surrounded by luxury homes, homeowners in the subdivision across the street may anticipate an increase in their property values.

Anticipation is the foundation of the income approach to appraisal.

**Contribution**

Contribution says that a particular item or feature of a home is only worth what it actually contributes in value to that piece of property. Thus, if a five-bedroom home is not desirable, putting an addition onto a house to add a fifth bedroom doesn’t increase the value of the home that much. The owners of the house may want or need a fifth bedroom, but they should not expect it to add significantly to the value of the home when it’s sold.

The value of an item or improvement is only equal to what a prospective buyer is willing to pay for it, not what it cost the owner to install or construct it. The theory of contribution is trickier when it comes to repairs. Necessary repairs may or may not add value to a property, depending on where the value started.

**For Example**

Just because a $100,000 house needs a new $5,000 roof does not mean the value of the house automatically increases to $105,000. The new roof may be a required feature that helps to sell the home, but it isn’t necessarily worth $5,000 more. This would be an example of negative contribution.

On the other hand, if a home is in serious need of repair, the $4,000 spent on new siding could add significantly more value than just $4,000. This is especially true in a situation where progression is present. Of course, not every repair will have this effect.

**Decreasing Returns**

It’s important to understand the principle of decreasing returns, which says that beyond a certain point, the added value of an additional feature, addition, repair, etc., is less than the actual cost of that item. This is also called the principle of diminishing returns. In other words, you can add too much to a property and not be able to increase the price enough to recoup the money you’ve invested. A seller may still want or need to do something to the property, they just can’t expect to get the full cost of the labor and materials back when they sell. A project that is a decreasing return is said to be infeasible.
**Increasing Returns**

The corollary to this is the principle of **increasing returns**, which says that the added value of an additional feature, repair, etc., is **more than the actual cost of that item**. Consider the example of a house in such need of repair that doing anything would have a dramatic increase in its value. Of course, a homeowner can go too far, and beyond a certain point, they will be back at the principle of decreasing returns. A project that is an increasing return is said to be **feasible**.

**Assemblage and Plottage**

*Assemblage* is **combining two or more parcels of land into one larger parcel**. This is typically done to increase the usefulness of the land. By allowing one larger building to be constructed on the combined parcels than could have been built on the individual parcels, the value of the land will also likely increase.

In fact, this one large parcel may be **worth more than the sum total** of the smaller parcels. This is referred to as **plottage**, which is an **increase in value (over the cost of acquiring the parcels) by successful assemblage, usually due to a change in use**. By creating a larger parcel with more utility and higher and better use than the individual sites, the owner has successfully achieved an increase in the inherent value of the land.

![Figure 15.1 Assemblage & Plottage](image)

**Subdividing**

Sometimes, **subdividing** property by **splitting it into multiple smaller parcels** can increase value. Suppose a house sits on 10 acres of land. If the property is not being used for farming or another specialized use that requires that much land, the owner might want to consider splitting it into two parcels: one parcel of five acres with the house and another, separate five-acre parcel.
Of course, the specific property and market would need to be analyzed, but it's very likely that the value of the house with just five acres would be similar to the house with its 10 acres. Since the owner has an additional five-acre parcel of land to sell or develop, he increases the total maximum productivity and profitability of the land.

**Pricing Properties**

One of the first things a seller wants to know is how much the licensee thinks the property should list for. Sellers often turn to a real estate professional to help them set a price, of course. The licensee offers knowledge, experience, and information that the average person usually doesn't have. Since the seller often relies on the licensee’s advice to determine the price, licensees must avoid over-representing or under-representing the value of the property.

Two tools available to licensees are the comparative market analysis and the net-to-seller calculation.

> When putting a property up for sale, it is ultimately the seller’s responsibility to determine the listing, or asking, price.

**Comparative Market Analysis**

A comparative market analysis (CMA), also called a competitive market analysis, is a method of determining the approximate market value of a subject property by comparing it to other similar properties in a given area that have sold, are presently for sale, or did not sell.

A real estate licensee typically develops a CMA for the benefit of a seller—who wants to know what to ask for his property—or a buyer—who wants to know what to offer for a property. Sometimes a lender may ask a real estate licensee to provide a similar analysis called a broker price opinion, or BPO. This may be needed, for example, when a property that is owned by the bank through foreclosure will be sold at auction.

Regardless of the purpose, it's important to remember that, although a CMA and a BPO are similar to an appraisal, they are *never equal to an appraisal!* Therefore, a CMA or BPO cannot be used to determine property value for a federally regulated loan.

> Some states require a licensee to disclose this fact in written form when providing a comparative market analysis or a broker price opinion.

**Properties for Comparison**

As a general rule, a CMA should consider all similar homes that have entered the market. This includes the following:

- **Active.** Homes currently listed for sale in the market, both from the multiple listing service (MLS) and any homes for sale by owner (FSBO)
- **Sold.** Homes that have sold recently (typically within the past six months or so) in the market and area where the subject is located
• **Expired.** Homes where the listing agreements have expired because the home was not sold during the listing period

• **Withdrawn.** Homes that were taken off the market

This “whole market” approach is the most reliable method of doing CMAs. It gives licensees, sellers, and buyers more complete information.

**HOMES THAT DID NOT SELL** Homes that didn’t sell can often provide more useful information to a licensee and prospective buyers or sellers than homes that are currently for sale. This is because the market’s reaction to the home has already been determined. If a home didn’t sell, that could mean that it was overpriced, didn’t have the features desired by the marketplace, or that there was an oversupply of houses in the market. This non-sale indicates that the current subject home should be priced lower than the non-sale home (assuming that the home is comparable to the subject) in order to attract buyers and market activity.

A seller may still insist on trying to get more for a home—and perhaps this can be justified by one or more features of the subject home—but the market has spoken. The home may still find a buyer at the higher price, but it is likely that it will take more time and effort to accomplish this.

**SOLD HOMES** The next obvious question is: Why can’t I just look at properties that have sold? The assumption is that if a house sold, then it must have been priced right. While this logic appears sound, it’s not complete.

First, it’s possible that there was a unique buyer who needed a particular house or was under duress to purchase something quickly, so an individual sale cannot be used to justify the price of the subject property. Second, it is impossible to know all of the factors that went into an individual buying decision. Third, the competition that existed in the marketplace at that time cannot be determined only by looking at homes that sold. And finally, the entire market must be considered to arrive at the best price for the subject property.

**Market Conditions**

Licensees must consider the impact of current market conditions when developing a CMA, for example, the general supply and demand of homes, local economic issues, availability of credit, etc. The stability and health of the real estate market as a whole directly impacts your business and what your prospective clients can expect—whether they are buying or selling a home. If market conditions are favorable, homes are likely to sell faster than in a slow market. Of course, this determines your marketing strategy and is why researching the area’s market conditions is an important component of a CMA. If there are more competing properties, it may take longer to sell.

Sometimes it may even be beneficial to look at seasonal conditions, like weather, holidays, or time of year for school. If the market is favorable, though, these conditions rarely have an impact on the sale.

**Days on Market**

Looking at the days on market (DOM) for each of the homes provides a rough idea of how long the subject property might take to sell. It might also be necessary to consider the total number of houses currently for sale as an indication of the current supply and demand situation in the marketplace.
For Example

With only six listings sold in the last 125-180 days (about one house sold per month), it would take about 18 months for the market to absorb the 18 listings that are currently on the market. If the seller wants a property sold sooner, she should consider a more aggressive pricing strategy (i.e., a lower price) to make the home more attractive in the marketplace. Seasonal markets and changes in outside influences, such as the current employment environment, will have a significant bearing on analyzing the pricing strategy.

Other Data Considered

Like an appraisal using the sales comparison approach, a CMA compares the assets and drawbacks of the subject property to those of several comparable properties. A CMA, however, is primarily concerned with the observable differences between houses that would draw a buyer to one house over another. The original cost of the house is irrelevant. Examples of factors to consider include:

- **Size.** Lot size, square footage, room counts, number of stories, etc.
- **Location.** On a cul-de-sac, near water, on a golf course, etc.
- **Buyer appeal.** Architectural style, construction and building materials, landscaping, etc. While subjective, this factor, sometimes called curb appeal, is critical.
- **Condition.** Age and relative condition of the property.
- **Neighborhood.** Amenities such as public transportation, parks, access to shopping, infrastructure, schools, etc.

This information can come from many different sources, for example, the multiple listing service, personal inspection, in-company listing data sheets, tax assessment rolls, etc.

Real Success

You will find that many sellers think their property is exceptional and will garner the highest price you have presented, even if you show them why it is unlikely they will be able to sell it for that price.

When discussing a possible listing price with a seller client—or offering price with a buyer—you might want to consider the value characteristic of contribution. Remember that this states that a particular item or feature of a home is only worth what it actually contributes in value to that piece of property, not what it actually cost the owner to install or construct it. For example, the seller may think that the custom-built wine cellar, which cost him $12,000 to build, should translate to a $12,000 bump in the asking price. But if a custom-built wine cellar is not a desirable feature for most prospective buyers, the seller cannot expect his pet project to add significantly to the value of the home when it’s sold.

You think a house should list for $220,000 but your seller insists that he wants $249,000. What is the importance of the number to you? You have an obligation to defend that price against objections from buyer customers under all circumstances.

If you are the listing agent, you are obligated to act in the best interests of your client, the seller. And if he wants $249,900 for their property, your obligation—if you take that listing—is to get him $249,900.

What if the property is only worth $220,000? That stays confidential and you still try to get $249,900, or you can refuse the listing. But, if you do take an overpriced listing, you cannot tell a buyer that if they make an offer of $225,000, you’ll talk the seller into accepting it. That would be a breach of the statutory obligation to act in your client’s best interest.

Use caution in these situations. Remember, sellers have a right to want whatever they want for their property, and licensees have the right to not take a listing if the seller is unrealistic about what it’s going to sell for. It may be more prudent to walk away from this listing rather than try to sell it for more than the market supports. In the end, sellers will be frustrated their property is on the market longer than expected, and you will be frustrated because your marketing effort is not producing a sale.
**Seller’s Share**

Sometimes a seller makes a pricing decision based not on what the market says would be the appropriate selling price, but what the seller wants—or needs—to make on the sale of the property. For example, the seller wants to pay off an existing mortgage and have enough for a down payment on the next house. That’s where the computation of **seller's share** is important.

**Seller's share**, or **net to seller**, is *an estimate of the money a seller should receive from a real estate transaction based on a certain selling price after all costs and expenses have been paid*. Also known as the seller's **net equity**, this is **not** a guarantee but an approximation of what the seller should receive. Seller's share is an important factor for a seller in **determining the listing price** of his property and **what price to accept** in a final offer from a buyer.

To find the seller's share from a transaction, simply start with the sales price and deduct all known costs for which the seller is responsible, such as broker's commission, pay-off of existing liens, prorated taxes, title insurance, recording fees, etc.

### Using Seller’s Share to Determine List Price

Using seller's share to determine a list price requires a little more work since it's necessary to account for the commission percentage when the sales price is unknown.

#### For Example

A seller wants to net $100,000 on the sale of his house to pay off his car and make a down payment on another house. The seller needs $120,000 to pay off an existing mortgage and approximately $10,000 more for estimated closing costs. That's $230,000. The listing agreement indicates the seller will pay the listing broker 6% of the sales price. It might be tempting to add 6% to that $230,000, but that would not be the correct answer. Instead, subtract the commission percentage from 100%: 100% - 6% = 94%. That $230,000 is 94% of the minimum selling price required to achieve the seller's desired net.

Now we can return to Circle-Math. The desired net plus known expenses is the Part, so it goes on the top. The sales price is the Total, so it goes on the bottom, along with the percent (100% - commission percentage). Once you plug in the numbers, Circle-Math allows you to solve the problem:

$$\text{Part} \div \text{Percent} = 244,680.85$$

The seller needs to sell the house for at least $244,681 (rounded) to net $100,000 after all designated expenses.
**Challenge Activity**

*Match the term to the definition.*

<table>
<thead>
<tr>
<th>A. Anticipation</th>
<th>F. Plottage</th>
</tr>
</thead>
<tbody>
<tr>
<td>B. Appraisal</td>
<td>G. Price</td>
</tr>
<tr>
<td>C. Arm’s Length Transaction</td>
<td>H. Progression</td>
</tr>
<tr>
<td>D. Highest and Best Use</td>
<td>I. Reconciliation</td>
</tr>
<tr>
<td>E. Market Value</td>
<td>J. Substitution</td>
</tr>
</tbody>
</table>

1. Probable price a property should bring in an open market when sold through an arm’s length transaction.
2. Most profitable legally permitted, financially feasible, and physically possible use of a parcel of land.
3. Economic principle that says value is created by the expectation of future benefits.
4. Process of analyzing the values derived from the different appraisal approaches to arrive at a final opinion of value.
5. Amount a ready, willing, and able buyer agrees to pay for a property and a seller agrees to accept.
6. Transaction that occurred under typical conditions in the marketplace.
7. Economic principle that says an informed buyer will not pay more for a property than a comparable substitute.
8. Opinion of value of adequately defined real property as of a specified date, supported by objective market data.
9. An increase in value by successful assemblage.
10. Increase in value to the worst home in the area because of its location.

**Summary**

1. An appraisal is the act or process of developing an opinion of value. An appraisal is merely an opinion of value, not a guarantee or determination. The appraisal is valid only as of the effective date of the appraisal; it does not predict future value. An appraiser is a person who is expected to perform valuation services competently, independently, impartially, and objectively.

2. The Appraisal Foundation was formed as a nonprofit corporation with an Appraisal Standards Board to develop, interpret, amend, and publish the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP is recognized throughout the U.S. as the accepted standards of appraisal practice. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) recognizes USPAP as the current industry standard for appraisal and identifies the Appraisal Foundation as the authority for professional appraisal standards. All appraisals in excess of $250,000 for use in connection with any federally related transaction must be performed only by licensed or certified real estate appraisers.
3. Value is the amount of goods or services offered in the marketplace in exchange for something. Maximizing value requires four value characteristics (D-U-S-T): Demand, utility, scarcity, and transferability; and three physical characteristics: Immobility, indestructibility, and uniqueness. Buyers must want the home, feel it’s useful to satisfy their needs, perceive a limited supply, and be free to transfer the home later. **Uniqueness** can help or hurt a property, and **scarcity** is due to limited land.

4. Physical (property specific) factors in an appraisal are highest and best use, location, substitution, conformity, and contribution. **Highest and best use** is the most profitable, legal, feasible, and physically possible use of land. **Location** is the exact position of land. Progression occurs when the “worst” home’s value is positively affected by other nearby homes; regression occurs when the “best” home’s value is negatively affected by other nearby homes. **Substitution** is the principle that an informed buyer won’t pay more for a home/feature than a comparable substitute. **Conformity** is the principle that a home achieves maximum value when surrounded by like homes. **Contribution** is the principle that an item is worth only what it contributes in value to real estate. The **law of diminishing returns** says that, beyond a certain point, the added value of an item is less than its actual cost.

5. Types of value include: **Market value**—the theoretical price real estate is most likely to bring in a typical transaction; **loan value**—the amount a lender is willing to let someone borrow for a property; **insurance value**—the amount property can be insured for (usually replacement cost of building, with no value for land); and **assessed value**—the amount used to calculate taxes due (usually a percentage of market value).

6. **Market value** is seen as the most probable price by Freddie Mac, Fannie Mae, and USPAP. A typical transaction is an **arm’s length transaction**—a transaction that occurred under typical conditions in the marketplace where each party was acting in their own best interests.

7. **Value** and **price** aren’t always equal. **Value** is what a typical person would pay; **price** is what one specific person paid; and **cost** is the dollars needed to build. **Market value** is what the property is expected to sell for; **market price** is what the property actually sold for. Both value and price may have nothing to do with what a property actually cost to buy or build.

8. A **competitive market analysis (CMA)**, also referred to as a **comparable market analysis**, is a method of determining the recommended listing price and/or anticipated sale price of a property by comparing the subject property to other properties that have sold, are presently for sale, or did not sell in a given area. This is not the equivalent of an appraisal.

9. **Seller’s share**, or **net to seller**, is an estimate of the money a seller should receive from a real estate transaction based on a certain selling price after all costs and expenses have been paid. 1. Determine the desired net, which is the total of non-commission expenses (such as closing costs and mortgage pay-off) and the amount of cash the seller would like to get out of the transaction. 2. Subtract the commission rate from 100% to find the percent of the sales price left after paying commission. 3. Use Circle-Math to find the minimum sales price: Divide the desired net by the percent of sales price without commission.
Chapter Quiz

1. An appraisal
   A. is a prediction of future worth.
   B. guarantees the value of a piece of real estate.
   C. is an opinion of value.
   D. establishes the selling price of a property.

2. After an appraiser develops all three approaches to value, what is the next step in the appraisal process?
   A. analyze the data
   B. determine highest and best use
   C. prepare the appraisal report
   D. reconcile the approaches

3. The accepted standards of ethics and appraisal practice are known as
   A. BPO.
   B. CMA.
   C. URAR.
   D. USPAP.

4. Which is NOT an accepted appraisal approach?
   A. cost approach
   B. income approach
   C. highest and best use approach
   D. sales comparison approach

5. Which is an example of real estate put to its highest and best use?
   A. a flat, paved parking lot in downtown Chicago
   B. a house in a residential subdivision
   C. an old house on a major highway surrounded by commercial buildings
   D. a vacant lot

6. The amount that one particular person paid for a property is its
   A. cost.
   B. market value.
   C. price.
   D. value.

7. Which is NOT a value characteristic that must be present and perceived by the user and other potential users of the property?
   A. demand
   B. immobility
   C. scarcity
   D. transferability

8. To comply with a court’s judgment to pay back child support, H is forced to sell his cabin as quickly as possible, accepting far less than the property’s market value. This is an example of ____________ value.
   A. assessed
   B. insurable
   C. investment
   D. liquidation

9. Which CANNOT define a neighborhood’s boundaries?
   A. physical boundaries
   B. ethnicity of residents
   C. income level of residents
   D. upkeep and maintenance

10. An investor buys two adjacent parcels of land for $20,000 each. An appraisal shows that the combined parcel is now worth $50,000. The increase in value is an example of
    A. assemblage.
    B. frontage.
    C. plottage.
    D. subdividing.

11. A nice, well-kept house located in the heart of an all-residential area, surrounded by other well-kept houses of similar style and value is an example of
    A. conformity.
    B. contribution.
    C. regression.
    D. substitution.
12. S bought an empty lot on a quiet street of small, 40-year-old ranch homes. On the lot, he built a luxurious two-story, 4,500 square foot home. A few years later when he put the home on the market, its value will likely be held down by the other homes in the neighborhood. This is an example of
A. anticipation.
B. balance.
C. progression.
D. regression.

13. If a homeowner decides to install an in-ground pool in the back yard, she may or may not be able to recoup the cost of the pool when selling the house. What principle applies to this scenario?
A. anticipation
B. conformity
C. contribution
D. substitution

14. The principle of substitution says that an informed buyer would pay ________ for the property than what the buyer would pay to obtain a similar one with the same benefits and utility.
A. considerably less
B. less
C. more
D. no more

15. When determining a listing price, the value of an improvement is equal to
A. the amount the owner adds to the selling price of the home when the improvement is made.
B. what it actually contributes in value to that piece of real estate.
C. only what the owner spent on the materials necessary to make the improvement.
D. what it actually cost to make the improvement in both materials and labor.

16. An arm’s-length transaction is one that occurred
A. between a buyer and a seller who have a close family relationship.
B. only after the seller made concessions for closing costs.
C. under typical conditions where each of the parties were acting in their own best interests.
D. when the buyer purchased the property sight-unseen.

17. What is the most common use for a comparative market analysis?
A. determine the amount of depreciation for insurance purposes
B. provide an estimate of a home’s value for a refinancing transaction
C. recommend an appropriate market rent for an income-producing property
D. suggest a range of probable selling prices for a homeowner

18. What feature of a comp is considered in a sales comparison appraisal that is NOT generally considered in a competitive market analysis?
A. age
B. financing concessions
C. lot size
D. number of rooms

19. A seller needs to pay an estimated $2,000 in closing costs, $150,000 on his current mortgage, and wants $58,000 in cash for a down payment on another house. His listing agreement obligates him to pay 7% commission to the brokerage. What is the minimum selling price he can accept? Round your answer up to the nearest dollar.
A. $197,400
B. $218,400
C. $222,600
D. $225,807
20. A seller is selling her home. She needs to pay off a $96,000 first mortgage, a $12,000 second mortgage, and wants $10,000 cash in hand for herself. If her closing costs are $3,100 and she contracts to pay a 7% commission, how much must she sell the property for? Round your answer up to the nearest dollar.

A. $118,877  
B. $129,577  
C. $130,216  
D. $233,723
Some may perceive an appraiser as an individual who views a property and quickly forms an opinion of its value—somewhat like using a crystal ball. Few individuals outside of the appraisal profession and other closely related professions recognize the appraiser’s required degree of diligence that must take place prior to expressing objective opinions and conclusions. The appraisal is a critical factor that can make or break a real estate transaction, so it’s helpful for real estate licensees to understand the analysis process. This chapter examines the three approaches to appraisal.

After reading this chapter, you will be able to:
• Use the sales comparison approach to estimate property value.
• Use the cost approach to estimate property value.
• Use the income approach to estimate property value.

Key Terms
Amenity
Comparables
Direct Capitalization Rate
Economic Life
Effective Age
External Obsolescence

Functional Obsolescence
Gross Rent Multiplier
Improvements
Income Approach
IRV Formula
Net Operating Income (NOI)

Replacement
Reproduction
Reserves for Replacement
Sales Comparison Approach
Site Valuation
Subject Property
Sales Comparison Approach

The sales comparison approach—sometimes called the market data approach or the market comparison approach—is one of the most widely used approaches to determine value for residential, commercial, industrial, agricultural, and other properties. With proper analysis, this approach can provide a firm foundation for an opinion of value.

Market Activity

The sales comparison approach compares other recently sold properties in the same general location with the subject property to render an opinion of value. The subject property is the property being appraised. The properties used to support the opinion of value are the comparables, also called comps.

The sales comparison approach is considered the most useful and accurate of the three appraisal methods (if adequate comps are available) because it’s rooted in actual market activity. This approach, however, usually considers past sales that have actually closed. Properties currently for sale are not used as comparables since their final selling price hasn’t been determined. Appraisers must look at past sales for the objective evidence to support their analysis of property value based on what a typical buyer would pay. With a truly objective appraisal, a buyer should agree with the value and be willing to pay the same price for the property. By looking at enough comparable sales, the appraiser can assume that the resulting appraisal analysis reflects the actions of typical real estate buyers in the marketplace.

The integrity of the appraisal process depends on basing property value on the actions of a typical buyer, one acting in his or her own best interest, without undue pressure, influence, or emotional attachment, and who would rationally and readily accept a less expensive substitute if available.

Finding Comparable Sales

The sales comparison approach typically uses three or more comparable sales to arrive at a value figure in a residential appraisal. A minimum of three comps is required by most secondary market lenders, such as Fannie Mae, to ensure an accurate appraisal from sufficient data. Ideally, comparables should be recent sales, usually within six months prior to the date of the appraisal.

SAME MARKET AREA The ideal situation is to use recently sold comparables in the same neighborhood or market area as the subject property. The appraiser must use knowledge and judgment to select the best areas for comparably valued properties and make appropriate price adjustments, along with clear explanations for choosing those properties.

SIMILAR FEATURES While physical location is important, any comparable property must be close in style and other features to the subject property. Similarity in use and other externalities ensures that a typical buyer would see the properties as ready substitutes for one another.
SAME TRANSFER RIGHTS The subject property and the comparables chosen for comparisons should involve the same transfer of rights. For example, the subject of a residential appraisal typically involves a fee simple transfer, in which the entire bundle of rights is sold to the new owner. The appraiser should verify that the identified comparables were also a fee simple transfer.

ARM’S LENGTH TRANSACTION The comparables used as the basis for comparisons must have been part of an arm’s length transaction that occurred under typical conditions in the marketplace, with each party acting in his or her own best interests. For example, comparables should be eliminated if the parties were related, the property sold as part of a liquidation sale (e.g., foreclosure), or the transaction had other unusual terms or concessions.

Adjusting Comparable Sales

Since it may be difficult to find properties that are the same as the subject property in all respects, the sales comparison approach allows for adjustments. Adjusting properties is the process of making chosen comparables come as close as possible in features to the subject so that meaningful value comparisons can be made.

The appraiser can apply an adjustment to the comps for any amenity or condition that, in the marketplace, results in a difference in price between two properties. An amenity is any significant tangible or intangible feature that enhances and adds value to real estate. The rules for adjusting properties are simple:

- The subject property is the starting point and never changes.
- If the comparable is inferior to the subject, add to the comparable to make the properties equal. (Use CIA to remember this rule.)
- If the comparable is superior to the subject property, subtract from the comparable to make them equal. (Use CSS to remember this rule.)

This process repeats for each significant feature or condition that is different between the subject property and the comparables as of the day the comp was sold. After all adjustments are made, an appraiser can reconcile the adjusted prices of the comparables to estimate the value of the subject property, weighting the comps as appropriate—never averaging them.

Figure 16.1: The comps are similar to the subject property in all respects, except for the garage. From a separate analysis, the appraiser determines that $5,000 is the contributory value in this neighborhood for garages. The adjustment scenario is repeated for each significant feature that is different between the subject property and the comparables on the day they were sold.
**Matched Pair Analysis**

Value adjustments for each additional or missing feature in a comparable depend on a number of factors. Just as the significant features vary from property to property and market to market, the adjustment amounts do too.

Much of the basis for these adjustments is computed from a **matched pair analysis**, which is the process of developing the contributory value of specific property characteristics or features by comparing pairs of similar properties. Ideally, there should be only one different characteristic between the pairs being analyzed so the difference in sale price can be attributed directly to that feature. Of course, in reality, the analysis may be more involved, with multiple adjustments derived in some instances.

**Significant Features**

Adjustments are made to comparables only for **significant features**, generally **physical** features, but they can also be **features of the transaction**, such as when a sale occurred or financing terms. Some features are objective, such as the number of bedrooms, while other features are subjective, such as the condition. Also, significant features can change from area to area; for example, a view of the golf course in a golf course community or access to a waterway for riverfront property. Every feature doesn’t need to be considered every time since the object is to find comparables that are already as close as possible to the subject.

**Sequence of Adjustments**

Appraisers follow a specific sequence of adjustments so all comp values are adjusted consistently. Some adjustments must be made first because they are adjusted as a **percentage** of the comp’s sales price, rather than a set dollar amount. The rationale is to adjust for features affecting the overall property before adjusting for individual features.

The sequence of adjustments, in order of priority, is as follows:

1. Property rights conveyed, e.g., fee simple, leasehold interest
2. Financing terms, e.g., seller concessions, loan assumption
3. Market conditions, i.e., proximity to effective date of appraisal
4. Location, e.g., neighborhood, cul de sac, waterfront
5. Physical characteristics, e.g., condition, number of rooms, exterior finishes, other amenities

Fannie Mae (FNMA) and others in the secondary market limit the total adjustments that appraisers can make to comparables to provide some sort of benchmark as to how close the comps are to the subject property.
For Example

In forming a conclusion about the subject's value based on the comparable properties analyzed, the appraiser looks at the quality and quantity of data and uses experience and judgment for reaching a final indication of value. In this example, the appraiser recognizes that Comps #1 and #3 require the least total adjustments. Likewise, these same sales most closely reflect the subject's size in terms of square feet. Finally, the age of the subject is most closely related to Comps #1 and #3. The adjusted values of Comps #1 and #3 range from $140,554 to $140,650. Therefore, a final value opinion could logically be supported at a rounded conclusion nearest to these indications.

**Final Value Opinion: $140,500**

<table>
<thead>
<tr>
<th>Feature</th>
<th>Subject</th>
<th>Comparable #1 Adjustments</th>
<th>Comparable #2 Adjustments</th>
<th>Comparable #3 Adjustments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Address</td>
<td>61 Lake Ave.</td>
<td>127 Dock St.</td>
<td>39 Lake Ave.</td>
<td>168 Shore Dr.</td>
</tr>
<tr>
<td>Sale Price</td>
<td>?</td>
<td>$137,900</td>
<td>$149,500</td>
<td>$142,700</td>
</tr>
<tr>
<td>Date</td>
<td>---</td>
<td>21 Days</td>
<td>60 Days</td>
<td>85 Days</td>
</tr>
<tr>
<td>1. Location</td>
<td>Waterfront</td>
<td>Waterfront</td>
<td>Waterfront</td>
<td>Waterfront</td>
</tr>
<tr>
<td>2. Lot Size</td>
<td>100' x 115'</td>
<td>105' x 110'</td>
<td>130' x 130'</td>
<td>105' x 125'</td>
</tr>
<tr>
<td>3. Condition</td>
<td>Good</td>
<td>Average</td>
<td>+ $2,000</td>
<td>Good</td>
</tr>
<tr>
<td>4. Age</td>
<td>20 Years</td>
<td>17 Years</td>
<td>24 Years</td>
<td>21 Years</td>
</tr>
<tr>
<td>5. Exterior</td>
<td>Brick</td>
<td>Brick</td>
<td>Stone</td>
<td>Stucco</td>
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<tr>
<td>6. Sq. Ft.</td>
<td>1,750 sq. ft.</td>
<td>1,675 sq. ft. + $750</td>
<td>1,875 sq. ft. - $1,250</td>
<td>1,800 sq. ft. - $500</td>
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<tr>
<td>7. Total Rooms</td>
<td>7</td>
<td>6 + $1,000</td>
<td>8 - $1,000</td>
<td>7</td>
</tr>
<tr>
<td>8. Bedrooms</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>9. Bathrooms</td>
<td>2.5</td>
<td>2.5</td>
<td>3</td>
<td>- $500</td>
</tr>
<tr>
<td>10. Basement</td>
<td>Full</td>
<td>Full</td>
<td>Full</td>
<td>Full</td>
</tr>
<tr>
<td>11. Garage</td>
<td>2-Car Attached</td>
<td>2-Car Attached</td>
<td>2-Car Attached</td>
<td>2-Car Attached</td>
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<tr>
<td>12. Utilities</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<tr>
<td>13. Other</td>
<td>None</td>
<td>None</td>
<td>Pool - $2,500</td>
<td>Deck - $2,000</td>
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<tr>
<td>14. Terms of Sale</td>
<td>---</td>
<td>VA - $1,000</td>
<td>Conventional</td>
<td>Assumption - $1,000</td>
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<tr>
<td>Total Adjustments</td>
<td>---</td>
<td>+ $2,750</td>
<td>- $9,755</td>
<td>- $2,146</td>
</tr>
<tr>
<td>Adjusted Values</td>
<td>---</td>
<td>$140,650</td>
<td>$139,745</td>
<td>$140,554</td>
</tr>
</tbody>
</table>
Challenge Activity

Sales Comparison Approach Adjustment Practice

An appraiser is using the sales comparison approach to arrive at an opinion of value for a listed property. She selects three properties as comps, even though they have some differences from the subject property. Through matched pair analysis she determines the following values for various features:

- A bedroom has a value of $4,000
- A full bath has a value of $1,500
- A half bath has a value of $800
- A brick exterior has a value of $7,500

Using her notes, determine the adjustments:

<table>
<thead>
<tr>
<th>Subject Property</th>
<th>Comparable 1</th>
<th>Comparable 2</th>
<th>Comparable 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$288,000</td>
<td>$301,000</td>
<td>$290,000</td>
</tr>
<tr>
<td>Bedrooms</td>
<td>4 bedrooms</td>
<td>4 bedrooms</td>
<td>5 bedrooms</td>
</tr>
<tr>
<td>Adjustment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Full Baths</td>
<td>2 full baths</td>
<td>2 full baths</td>
<td>3 full baths</td>
</tr>
<tr>
<td>Adjustment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1/2 Baths</td>
<td>1 half bath</td>
<td>2 half baths</td>
<td>1 half bath</td>
</tr>
<tr>
<td>Adjustment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exterior</td>
<td>Brick</td>
<td>Vinyl Siding</td>
<td>Brick</td>
</tr>
<tr>
<td>Adjustment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indicated Value</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Cost Approach

The cost approach is \textit{an appraisal method that develops an indication of the value of real property by figuring:}

\textbf{Cost of Improvements} - \textbf{Depreciation} + \textbf{Value of the Vacant Land}

The cost approach is considered a more reliable method of indicating a value opinion for newer structures as typically there is less (if any) physical depreciation to consider. However, the method is also useful if the appraisal requires a replacement cost for a building. Other situations for which the cost approach is well-suited include the following:

- Valuing single-use or special purpose buildings for which there are few comparable sales, such as hospitals, schools, or houses of worship
- Finding the property’s insurable value
- Providing supporting evidence for other appraisal methods
The cost approach is also useful as a secondary check of other appraisal approaches developed by the appraiser, or to support the value indications reached through other methods.

It’s important to remember that cost does not always equal value. If a house is overbuilt (too many features) or a building has other forms of obsolescence, market value would likely be less than the cost of building. An informed buyer’s primary concern is what similar properties are selling for in the area, rather than the cost to build the house.

**Cost of Building or Improvement**

The cost of building a house or improvement on land can be determined in several ways. Before choosing a specific cost method, the appraiser must know whether the estimate is for replacing or reproducing the building. There’s a significant difference:

- **Replacement** of a structure is building the functional equivalent (substitute) of the original building using modern materials, methods, and design.
- **Reproduction** of a structure is building an exact duplicate (replica) of the original building.

Usually, cost estimates are performed for **replacing** a building with one that’s of similar size and utility. Most of the time, a similar building is an acceptable, less expensive alternative. Cost estimates for **reproducing** a building are typically done for historical buildings where it’s important for the new structure to have the exact same appearance and materials as the original structure.

**Square Foot Method**

Appraisers determine the appropriate costing method based on the scope of work determined early in the assignment. The most common costing method is the **square foot method**. This method relies on **cost manuals**, which are books, electronic media, and online sources that give estimated construction costs for various types of buildings in different areas of the country. Appraisers subscribe to these cost services, which are frequently updated. Cost manuals detail the “per-square-foot” cost of specific building types and can, if necessary, be broken down by individual components.

**For Example**

An appraiser is figuring the cost of a 1,250 square foot, one-story home in the Midwest. The cost service indicates a total cost per square foot of $48.65 (assuming replacement cost is being used), so 1,250 x $48.65 = $60,812.50 cost estimate.

**Depreciation**

**Depreciation** is a loss in value to property for any reason. Keep in mind that depreciation is never applied to the land itself; only improvements or enhancements depreciate. For the most part, depreciation refers to the building or structure on the land.
Factors contributing to depreciation can be classified as **curable** or **incurable**, which considers the cost of the repair vs. what the repair contributes to the value of the property.

- **Curable** indicates that the *cost to repair is less than the value the repair would contribute to the sale value.*
- **Incurable** indicates that the *cost to repair is more than the value the repair would contribute to the sale value.* That does not necessarily mean that the item should not be fixed, but it does provide a basis for deciding whether or not it is worth the time, effort, and money to repair a property’s shortcomings.

Regardless of cost versus benefit, if the repair **must be done**, the repair is curable. For example, if a repair is mandated by building codes, the owner must make the repairs even if the property value is unaffected by the repair.

Depreciation is usually attributed to one of three causes: Physical deterioration, functional obsolescence, or external obsolescence.

**Physical Deterioration**

**Physical deterioration** is *actual wear and tear on something due to age, the elements, or other forces.* Regular maintenance can slow the process, and many types of physical deterioration are repairable or **curable**. With the cost approach, the appraiser calculates a depreciation figure for physical deterioration by taking the new price of the item and subtracting a percentage for the wear and tear.

**For Example**

Based on an inspection, current wear and tear on an existing furnace appears to have diminished the furnace’s life by about 20%. A new furnace costs $5,000. So, $1,000 (5,000 x 0.20) is the amount of depreciation that should be attributed to that item. If an item must be replaced, the appraiser uses the entire new cost.

**Functional Obsolescence**

**Functional obsolescence** occurs *when a building is less desirable because of something inherent in the design of the structure* (e.g., an outdated home style, outdated fixtures, having only one bathroom). These undesirable features may be **curable** or **incurable**. The appraiser determines a depreciation figure for functional obsolescence using the cost of curing the undesirable feature or, for incurables, by comparing the differences in sale price from a property with the feature and one without it.

**External Obsolescence**

**External obsolescence** (sometimes referred to as **economic obsolescence**) occurs *when something outside the boundaries of a property makes it less desirable.*

**For Example**

External obsolescence may be caused by a general decline in a neighborhood, the closing of a plant that was important to the economic base of an area, a nearby landfill, or the construction of a new highway that creates noise or re-routes traffic.
These external causes are generally **incurable**—property owners can typically do little to stop or change these conditions. The appraiser determines a depreciation figure for external obsolescence by comparing the differences in sale price (market or matched pair analysis) from a property with the feature and one without the feature.

**Calculating Depreciation**

The most common methods of depreciation revolve around certain measures of time in the life of a structure or improvement. When a structure is first built, it has an expected **economic life**, which is the time it can be used for its intended purpose. The **actual age** of a structure or improvement is insignificant to depreciation. Rather than considering the actual age of the structure, the appraiser considers how old the building **appears** to be based on deterioration, which is its **effective age**. This may or may not be the same as its actual age.

The **age-life** method of calculating depreciation compares the structure's effective age to its economic, or useful, life. After determining the effective age, the formula to find the **age-life ratio** is:

\[
\text{Effective Age} ÷ \text{Economic Life} = \text{Age-Life Ratio}
\]

This ratio can be applied to the replacement or reproduction cost of the structure determined earlier to arrive at the accrued depreciation, and therefore, the value of the structure.

**For Example**

J is appraising a 30-year-old structure. He determines that the replacement cost (RC) of the structure is $200,000. The economic life (EL) of the structure should be 100 years, and J determines, based on its good condition, that the effective age (EA) is 25. Here's how he arrives at the value of the structure:

**Step 1:** 25 years (EA) ÷ 100 years (EL) = 0.25 (age-life ratio)

**Step 2:** $200,000 (RC) x 0.25 (age-life ratio) = $50,000 (accrued depreciation)

**Step 3:** $200,000 (RC) – $50,000 (accrued depreciation) = $150,000 (value of the structure)

**Site Valuation**

Once the value of the structure is determined, the last element in the cost approach formula is the **site value**, which is the value of the land with the enhancements necessary to make it ready for building, such as water, sewer, electricity, etc.

The site value must be **added** to the value of improvements to arrive at a final opinion of value for the property. Site value is most often determined using the **sales comparison approach**. Although land itself is said never to suffer depreciation, if the current or proposed improvements are **not** consistent with the **highest and best use** of the property, that factor would be addressed as an obsolescence and result in depreciation of the improvements.

The equation must also consider the contributory value of other site improvements not already considered in the cost calculations—such as driveways, landscaping, walkways, and, in some cases, utility provisions.
Income Approach

The income approach, sometimes called the capitalization approach, is very useful for appraising income-producing, or potentially income-producing, properties because it analyzes the rent or income and produces a direct correlation with the value of the property. This also makes it easy to make comparisons between properties. Investors are typically not emotional about their buying decisions and like to have objective means to compare properties. The income approach parallels the thought process typical investors go through when making a buying decision.

There are two methods used to derive value using the income approach:

- Employing a multiplier to analyze the market rent of a property, in other words, what the property should rent for if currently vacant and available.
- Direct capitalization using a direct capitalization rate to analyze the net income stream produced by the commercial or investment property.

Gross Rent Multiplier

The gross rent multiplier (GRM) expresses a relationship between an anticipated income stream (often monthly or annual gross rent) and value. The GRM, which may also be referred to as the GMRM or gross monthly rent multiplier, is most commonly used for one- to four-unit residential properties. The GRM identifies the subject property’s ranking within the market of similar properties by giving a means of comparing gross monthly rent to property sales prices, or value. Once this factor or multiplier is estimated, it can be used to estimate the value of other properties. This method can also help support value estimates derived from other appraisal methods.

A similar calculation may be used on small commercial investment properties, but it considers annual income from all sources, for example, revenue from coin-operated laundry facilities or vending, rented parking spaces, etc., in addition to rent. This helps prevent a distortion in the estimate due to seasonal fluctuations. This may be referred to as gross income multiplier, or GIM.

Either monthly or annual income can be combined with an appropriate GRM or GIM and the resulting value would be the same. The nature of the income stream and preferences in the local market dictate whether monthly or annual computations should be used.

Neither the GRM nor the GIM give any consideration to a property’s profitability since it does not take into account expenses, losses, or the debt service, which is the paying down of any financing debt. Rather, it is a benchmark to gauge the property’s potential profitability by analyzing the potential gross income against the investment dollars needed to buy that future income stream.

Deriving the Multiplier

The multiplier is derived using a very simple formula. Data is collected on a number of rental properties that have recently sold in a certain area. The selling price (value) for each is divided by the gross monthly rent the property commanded in the marketplace (income), thus arriving at the gross rent multiplier.
**For Example**

An appraiser is evaluating a single-family rental home for a lender. The market rent for the subject property is $950 per month. The appraiser researches and analyzes transaction data from the market and identifies an indicated multiplier. The following is revealed:

<table>
<thead>
<tr>
<th>Sales Price</th>
<th>Market Rent</th>
<th>GRM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 $112,500</td>
<td>$915</td>
<td>122.95</td>
</tr>
<tr>
<td>2 $121,255</td>
<td>$980</td>
<td><strong>123.73</strong></td>
</tr>
<tr>
<td>3 $124,180</td>
<td>$1,010</td>
<td>122.95</td>
</tr>
<tr>
<td>4 $114,524</td>
<td>$925</td>
<td>123.81</td>
</tr>
<tr>
<td>5 $117,900</td>
<td>$900</td>
<td>131.00</td>
</tr>
</tbody>
</table>

In the final analysis of the developed range of multipliers, the appraiser notes that the most common result in this example is around 123.00, with those results ranging from just slightly less than 123.00 to the upper 123.00 range.

In reconciling a GRM conclusion, she chooses to place most weight on property #2 (123.73) and property #4 (123.81), since the multiplier from those transactions most closely brackets the subject's estimated market rent of $950. For this reason, she chooses a multiplier of 123.75 to apply to the subject. Now she can apply the gross rent multiplier to determine an estimated value:

\[ \text{GRM} = \frac{\text{Sales Price}}{\text{Market Rent}} \]

\[ \text{Estimated Value} = \text{Market Rent} \times \text{GRM} = 950 \times 123.75 = 117,562.50 \]

**Capitalization Rate**

Since the gross rent multiplier does not consider a property’s profitability—in other words, it does not consider operating expenses and losses—it gives a limited snapshot of value. The other basic formula that appraisers use to estimate the present value of future income is the capitalization rate, also called the cap rate or direct capitalization rate. Generally, appraisers use the cap rate for larger residential properties with more than four units, or for nonresidential commercial properties.

**Net Operating Income (NOI)**

Before calculating the capitalization rate or estimating value, it’s necessary to find the annual net operating income, or NOI. The NOI is one of the first indicators of the real value of an investment property. The mathematical formula for NOI is shown:

\[ \text{PGI} - \text{Vacancy/Collection Loss} + \text{Other Income (Misc.)} - \text{Total Fixed and Variable Expenses} = \text{NOI} \]

While the formula steps may seem outwardly simple, the appraiser may spend a significant amount of time in analyzing the various components leading to an estimated NOI.
POTENTIAL GROSS INCOME (PGI) Potential gross income is the total annual income the property could produce in an ideal situation, with no vacancy or collection losses.

VACANCY AND COLLECTION LOSSES Every property owner, at one time or another, will experience some period of vacancy during the year and occasionally some tenants will fail to pay the rent (collection losses). These are usually represented as a percentage of the potential gross income.

MISCELLANEOUS INCOME Any money earned other than rent, such as from a coin-operated laundry, parking or storage fees, should be included as miscellaneous income.

EFFECTIVE GROSS INCOME Effective gross income (EGI) is the potential gross income, less vacancy and collection losses, plus any miscellaneous income. If PGI is what the property owner could have taken in, EGI can be thought of as what that property owner did take in.

OPERATING EXPENSES Operating expenses are day-to-day costs of running a property, such as repairs and maintenance, but not including debt service or depreciation. Operating expenses are divided into three types:

- **Fixed expenses.** Ongoing expenses that do not vary based on occupancy levels of the property, such as insurance or property tax.
- **Variable expenses.** Operating expenses necessary to the property, but dependent on the property’s occupancy level.
- **Reserves for replacement.** An amount of money set aside for future replacement of major items.

NOI does not consider the financing of the property (debt service) because property value should be independent of any financing obtained to acquire it. Nor does NOI consider depreciation.

**Deriving the Cap Rate: IRV**

The cap rate is a rate of return, stated as a percentage, used to derive a value opinion from the anticipated net operating income a property could generate. It is derived from market data using the IRV formula, which relies on three variables:

- **Income.** The amount of money a property earns. The capitalization rate method needs the annual net income or net operating income (NOI).
- **Rate.** The return on the purchase price of the property, the capitalization rate. An appraiser evaluates comparable properties in the marketplace to determine the appropriate cap rate to use in the IRV equation for estimating value.
- **Value.** The worth of the investment, what someone is willing to pay for a property at a given moment in time.
For Example

F is interested in buying a 10-unit strip mall as a rental property and wants to know an appropriate offer price. Each unit rents for $1,000 each month with no miscellaneous income. The vacancy rate is 5%, and the annual expenses come to $30,000. The appraiser first determines the net operating income:

- $120,000 Potential Gross Income
- 5% Vacancy Rate
- $114,000 Effective Gross Income
- $30,000 Expenses
- $84,000 Net Operating Income

The appraiser evaluates three similar properties in the county and finds the following (rounded):

<table>
<thead>
<tr>
<th>NOI (Income)</th>
<th>Sales Price (Value)</th>
<th>Cap Rate (Rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 $83,200</td>
<td>$978,800</td>
<td>= 8.5%</td>
</tr>
<tr>
<td>2 $96,910</td>
<td>$1,160,600</td>
<td>= 8.35%</td>
</tr>
<tr>
<td>3 $87,164</td>
<td>$990,500</td>
<td>= 8.8%</td>
</tr>
</tbody>
</table>

The appraiser recommends a cap rate of 8.5%. To find the value (i.e., offer price), plug the known factors into the IRV formula:

\[ \frac{\text{NOI (Income)}}{\text{Rate (Rate)}} = \text{Value (Value)} \]

\[ \frac{84,000}{0.085} = 988,235 \]

Buyers can also determine what they’re willing to pay for a property by considering their desired rate of return. If this buyer wants a 9.25% return, for example, she may be willing to pay only $908,108 for the property ($84,000 ÷ 0.0925 = $908,108).

Cap Rate and Risk

Note the correlation between value and cap rate. As the cap rate increases, the value decreases, which might seem counter-intuitive. The cap rate, however, is tied to risk. A higher cap rate indicates an investment that may be riskier or may take longer to show a return. Cautious investors, therefore, will likely pay less to purchase a property with a high cap rate.
## Advantages and Disadvantages of the Three Appraisal Approaches

<table>
<thead>
<tr>
<th>Approach</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Comparison</td>
<td>• The most accurate of the three appraisal methods (if good data is available) as it relies on actual market activity  &lt;br&gt; • Adjusts comps so they more closely approximate the actual features and conditions of the subject property  &lt;br&gt; • Works for most residential and commercial property</td>
<td>• Requires comparable properties to have been sold recently in the area  &lt;br&gt; • Not suitable for special-purpose properties, such as schools, churches, etc., and unusual or unique properties</td>
</tr>
<tr>
<td>Cost</td>
<td>• A very useful and accurate estimate of value for special-purpose properties  &lt;br&gt; • Uses extensive data and considers depreciation  &lt;br&gt; • Excellent for new or unusual properties and for insurance purposes</td>
<td>• The cost of a building does not necessarily equal its value  &lt;br&gt; • Consideration of several market factors is necessary to make an accurate estimate of value</td>
</tr>
<tr>
<td>Income</td>
<td>• Most useful for income-producing properties, such as commercial or residential rental real estate  &lt;br&gt; • Ability to solve for any variable: income, value, rate of return  &lt;br&gt; • Gives a method to analyze the value of a future income stream</td>
<td>• Not useful for non-rental residential property  &lt;br&gt; • Income figures and expenses represent past income performance of property  &lt;br&gt; • Attempts to introduce future vacancy, collections, and other losses into the equation are merely a guess</td>
</tr>
</tbody>
</table>
Summary

1. The **sales comparison approach** is an appraisal method in which an appraiser develops an opinion of value by using market data and analyzing comparable sold properties. It can be a very reliable method for developing an opinion of value given there is sufficient reliable data which may be analyzed. For most appraisals for mortgage finance transactions, at least three comparable sales are analyzed. **Comparables**, ideally, should be recent sales, physically similar to the subject, and in a similar market. **Adjustments** are made to comparables for differences. The comparable is always adjusted and never the subject. If the comparable is inferior, an adjustment is added to the comparable; if the comparable is superior, an adjustment is subtracted from the comparable. Adjustments are made only for features or conditions of the property as of the day the comparable sold; adjustments are made only for significant features; and adjustment totals are sometimes limited. The dollar amount of adjustments is determined by **matched pair analysis**. **Priority of adjustments**: Financing concessions, terms of sale, date of sale, location, and physical features or differences.

2. The **cost approach** estimates the cost of building a structure, minus depreciation, plus the value of the land. The cost can be based upon **replacement cost** (the functional equivalent of the original) or **reproduction cost** (an exact replica of the original). However, replacement cost is more common. **Cost manuals** are used in the **square foot method** to give costs of construction for different types of buildings. The book figure is multiplied by the structure's square footage to estimate the cost. **Depreciation** is a loss in value for any reason (**physical deterioration**, **functional obsolescence**, **external/economic obsolescence**) and can be **curable** (the cost to cure is less than the resulting value) or **incurable** (the cost to cure is more than the resulting value).

3. The **income approach** analyzes the revenue or income a property generates. For residential properties, the **gross rent multiplier** (**GRM**) is most often used. This also may be referenced as the gross monthly rent multiplier (**GMRM**). To derive a GRM, the prices of other similar rentals are divided by the monthly rent. The GRM is then multiplied by the subject's rent to indicate a value. With smaller income-producing properties, appraisers may use **annual income** figures, in which case, it's called the **gross income multiplier** (**GIM**). In direct capitalization, the **cap rate**, or **rate**, is a percentage used by investors to calculate the present value of future income using the **IRV formula** (**Net Operating Income (NOI) ÷ Rate = Value of the Property**). The annual net operating income is determined by subtracting operating expenses and a percentage for **vacancy and collection losses** from the **gross income**. Debt payments and depreciation are not included in operating expenses. Although the rate and acceptable risk vary among investors, the rate compares the relative investment risk.
Chapter Quiz

1. An appraiser has been contracted to determine the value of a large apartment building for a potential investor. Which appraisal method is probably the most useful for this situation?
   A. competitive market analysis
   B. cost approach
   C. income approach
   D. sales comparison approach

2. Which homes should an appraiser consider when finding comps?
   A. homes currently listed for sale in the market
   B. homes for which the listing agreements have expired
   C. homes that have sold recently in the subject’s area
   D. All homes should be considered.

3. Comp #3 has five bedrooms; the subject property has four bedrooms. Through matched pair analysis, the appraiser determines that a bedroom in that neighborhood is worth $7,500. What is the appropriate way to apply this information when performing the sales comparison approach to valuation?
   A. add $7,500 to Comp #3 value
   B. subtract $7,500 from Comp #3 value
   C. add $7,500 to the subject base
   D. subtract $7,500 from the subject base

4. When completing the sales comparison approach, which is considered first in the sequence of adjustments?
   A. date of sale
   B. location
   C. physical differences
   D. property rights conveyed

5. Comp #3 has three bathrooms; the subject property has four bathrooms. A bathroom in that neighborhood is valued at $4,000. Comp #3 does not have a fireplace; the subject does. A fireplace is valued at $6,000. Comp #3 has a finished basement; the subject does not. A finished basement is valued at $12,000. Comp #3 sold for $200,000. What is the comp’s adjusted value?
   A. $198,000
   B. $200,000
   C. $202,000
   D. $210,000

6. A building has an effective age of 20 years, an actual age of 10 years, and a total expected life of 70 years. What is the remaining economic life of the building?
   A. 30 years
   B. 40 years
   C. 50 years
   D. 60 years

7. Which home suffers from external obsolescence?
   A. Home A allows access to the basement only from outside of the home.
   B. Home B has only a detached one-car garage.
   C. Home C has a crumbling foundation.
   D. Home D is less than 500 yards from the county dump.

8. An appraiser used various cost manuals and regional multipliers, as well as her own experience, to determine that it would cost $69 per square foot to replace the subject property. Since the property is 2,880 square feet, she determines it would cost $198,720 to rebuild the house. To find the value of the subject property, she must also factor in
   A. depreciation and land value.
   B. depreciation and inflation.
   C. inflation and labor costs.
   D. labor costs and land value.
9. Which of the following would NOT suffer from depreciation?
   A. an abandoned building
   B. a residential property used as a rental
   C. unimproved land
   D. a 2,700 sq. ft. commercial building

10. Reproduction cost, as opposed to replacement cost, is typically considered for which type of structure?
    A. historical buildings
    B. personal homes
    C. restaurants
    D. schools

11. The second bedroom of a house must be accessed through the first bedroom. This is an example of
    A. economic deterioration.
    B. external obsolescence.
    C. functional obsolescence.
    D. physical depreciation.

12. An appraiser is analyzing a unique dome house for a mortgage. Using the square foot method, she determines that the replacement cost of the home would be $120 per square foot. The home has 2,150 square feet. She also determines that the effective age of the home is 20 with an economic life of 60 years. If the site is valued at $57,000, what would be the final opinion of value using the cost approach? Round up to the nearest dollar.
    A. $201,000
    B. $228,983
    C. $229,008
    D. $315,000

13. For which of these properties would the gross rent multiplier method be MOST appropriate?
    A. a single-family home that is owner-occupied
    B. a duplex
    C. a retail complex with three units
    D. an apartment building with five units

14. A duplex recently sold for $200,000. It brings in monthly rental income of $900 per unit. The expenses for this property run $8,000 per year. What is the gross rent multiplier for this property?
    A. 9.26
    B. 14.7
    C. 18.52
    D. 111.11

15. An appraiser determines that the three-unit residential rental property takes in $600 each month in rent per unit. She estimates a vacancy loss of $1,800 per year. She also determines, based on current market data, that the GRM should be about 121. What is the estimate of value for the subject property?
    A. $72,600
    B. $145,200
    C. $199,650
    D. $217,800

16. Of these expenses, which would NOT be included in the calculation to find net operating income?
    A. depreciation
    B. property management fees
    C. reserves for replacement
    D. property tax

17. A buyer is considering a six-unit apartment. Similar properties in the neighborhood show a cap rate of 10%. If that return is acceptable to the buyer, how much would he theoretically be willing to pay for a property with an NOI of $40,000?
    A. $200,000
    B. $250,000
    C. $400,000
    D. $440,000
18. An appraiser is trying to determine an appropriate cap rate for the assignment. When looking at a comparable property, he learns that the NOI is $14,400 and the property sold for $200,000. What is the capitalization rate for that comp?
   A. 2.9%
   B. 7.2%
   C. 8.6%
   D. 13.8%

19. The rent for each office in a building with 10 small suites is $2,000 per month. It averages 20% vacancy and earns $1,000 a year from the parking meters. Annual expenses run $108,000 per year. If the appraiser determines the market-area cap rate to be 9.5%, what is the value of this property (rounded)?
   A. $807,500
   B. $852,632
   C. $894,737
   D. $1,120,000

20. An appraiser evaluates a 60-year-old duplex. He estimates that such a structure should have an economic life of 100 years, but its condition is very good, so he puts the effective age at 40. He determines the replacement cost for such a structure is $460,000 and the value of the site is $120,000. Using the cost approach formula, what is the most likely opinion of value?
   A. $276,400
   B. $321,600
   C. $304,000
   D. $396,000
Land Use and Environmental Issues

Land ownership can be absolute, meaning the complete bundle of rights belongs to the owner: The rights to control, enjoy, restrict, dispose of, and possess property. However, this does not mean landowners necessarily have the absolute right to control the land. The government, private companies, and even individuals who have interests in the real property sometimes place restrictions on land use. Public restrictions—such as zoning ordinances, building codes, subdivision requirements, and environmental laws—can have a significant impact on the use and value of real property. Private restrictions—such as deed restrictions and subdivision regulations—can be just as impactful.

After reading this chapter, you will be able to:

• Recall the role of government entities in regulating land use and subdivision.
• Identify types of zoning and private restrictions on land use.
• Recognize the impact of environmental issues on real estate transactions.

Key Terms

Area Variance  
Asbestos  
Building Code  
Building Permit  
CC&Rs  
Certificate of Occupancy  
Comprehensive  
Comprehensive Plan  
Deed Restriction  
Eminent Domain  
Environmental Impact Statement (EIS)  
Environmental Site Assessment (ESA)  
Easement  
Just Compensation  
Inverse Condemnation  
Laches  
Mold  
Nonconforming Use  
Police Power  
Radon  
Residential Lead-Based Paint Hazard Reduction Act  
Restrictive Covenant  
Spot Zoning  
Use Variance  
Variance  
Wetlands  
Zoning
Government Interests

While Americans generally enjoy great freedoms related to land ownership, there are numerous restrictions on the way property owners can use their land, for example, the farmer who can't cultivate land because an endangered salamander lives there or the property owner who can't open a business in his garage because zoning ordinances prohibit it. These situations can be attributed to the regulatory authority of federal, state, and local government. Government authority includes police power, eminent domain, taxation, and escheat (remember P-E-T-E).

Police Power

Police power is the constitutional power of state and local governments to enact and enforce laws that protect the public’s health, safety, morals, and general welfare. These police powers often take the form of public restrictions imposed by the government at the local, state, and federal levels. Considering that each county in the state and each municipality in the county have their own land use regulations, it would be impossible to list all the controls individual municipalities have over land use, although these are common examples:

- Zoning ordinances
- Subdivision regulations
- Building codes
- Environmental laws

Eminent Domain

Eminent domain is the government's constitutional power to take private property for public use. Examples of public use could be a road, a railroad, a canal, utilities, or a park. Eminent domain is the right of the government to take the property. Condemnation is the legal proceeding by which that right to take land is exercised. Condemning authorities generally include the state and its authorized agencies, municipalities, school districts, railroads, public utilities, and the federal government.

Two conditions must be met before the government can exercise its power of eminent domain and take private property:

1. The condemned property is being taken for the use and benefit of the public.
2. The property owner is paid just compensation for the property taken, which is usually its market value.

Condemnation cannot occur without due process of law. Proper notice must be given, and property owners who disagree with the compensation offered have the right to present evidence to support their claim in court.

EASEMENT BY CONDEMNATION An easement is a nonpossessory right to use someone's land. The government can use its constitutional power of eminent domain to bring a condemnation lawsuit against a property to create an easement, as well as to obtain fee simple title to that property.

Public or Private Use

In 2005, the U.S. Supreme Court ruled in the controversial case of Kelo v. City of New London that the government may condemn property and then sell it to a private developer, concluding that the increased tax revenue and economic development would benefit the public.
Despite the ruling, the developer in this case walked away from the project, and the land sat empty for years. As a result of this case, some states have passed statutes limiting condemnation proceedings.

Nonetheless, without the right of eminent domain, the government would be forced to negotiate the purchase of any land needed to build roads, dams, sewage treatment plants, etc., at a price likely to be much higher than the value of the land. It would be virtually impossible, therefore, for the government to provide for the public good.

**Taking**

A **taking** occurs when *the government acquires private property for public use by appropriation without just compensation*. A **Regulatory taking** occurs when the government regulates the use of private property to the point that the owner is deprived of any economically reasonable use or value. In the 1992 case of *Lucas v. South Carolina Coastal Council*, the U.S. Supreme Court ruled that a taking is **unconstitutional** if it prohibits the construction of any habitable or productive improvement on the owner's land and eliminates all economic benefits associated with the land.

**Inverse Condemnation** If a property owner believes that the government has **not** paid just compensation when appropriating property through the power of eminent domain, the homeowner has the right to initiate a lawsuit against the government to recover additional money.

**Taxation**

In addition to police powers and eminent domain, the government has the authority to pass **revenue-generating laws**. **Taxation** is *the process of the government levying a charge on people or items*. For example, **ad valorem property taxes** are imposed on property owners by local government entities to pay for schools, improvements, or other public needs. Some tax policies have a direct and deliberate effect on real estate. On state and local levels, for example, tax breaks can be given to businesses as an incentive to bring jobs or real estate development to an area.

**Special assessments** are taxes levied only against properties that benefit from a public improvement (e.g., a new sewer line). These special assessment taxes are not permanent. Once the property owner's contribution to the cost of the benefit is paid, the tax ceases.

**Escheat**

The government also has the power of **escheat**. When a person dies **intestate**, that is, without a will, and has no heirs or creditors, **title to property reverts to the state** through escheat. **Abandoned** property also escheats. The state can then sell the property, ensuring that the government's interests are preserved: The land is no longer ownerless and, therefore, someone is responsible for paying property taxes on it.

Escheat applies to both **real property** and **personal property**, including unclaimed property such as neglected safe deposit boxes, forgotten dividends, or insurance policies.

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**P-E-T-E:**

- **Government Authority**
- Police power
- Eminent domain
- Taxation
- Escheat

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In some states, real property reverts to the county in which the property is located, not the state.
Municipal Agencies

An important part of a licensee’s job is being able to answer questions about a virtually endless range of topics. When questions arise outside of a licensee’s expertise, licensees should be prepared to point to an expert who can assist. Often, clients can find the information through various municipal agencies.

Planning Boards

Comprehensive planning is essential for city growth. Thoughtful and deliberate city planning allows for expansion that is consistent and balanced. Nearly every municipality has a planning board or planning commission that holds public hearings, investigates solutions for planning issues, and makes recommendations to the appropriate legislative authorities. Planning boards are generally involved in activities that directly affect the growth and development of a municipality, such as regulating the subdivision of land, reviewing site plans, and developing a comprehensive plan.

Comprehensive Plan

A comprehensive plan, also called a master plan, is a written document that identifies the goals, objectives, principles, guidelines, policies, standards, and strategies for the growth and development of a community, including its housing needs. It is up to the planning board to create the plan, in association with other government agencies and community leaders. The planning board also adjusts the plan as needed to address budgetary concerns, new land use regulations, new environmental issues, and other reasons unique to the community.

Planners look at a community’s needs and resources and, working together with local officials, develop both short-term plans and comprehensive long-term master plans to promote the best use of land as a region grows or is revitalized. The recommendations and goals of a master plan may be implemented by local authorities through the passage of zoning and subdivision ordinances, as well as through acquiring and budgeting public funds.

MORATORIUMS Occasionally, a planning board imposes a moratorium that temporarily suspends the right of property owners to obtain development approvals. This allows local entities time to consider, draft, and adopt land use regulations or rules to respond to new or changing circumstances not adequately dealt with by its current laws.

Building Departments

Landowners must obtain building permits before constructing or renovating residential or commercial property. Local building departments are responsible for issuing building permits and for seeing that building codes are followed and construction and renovation are done by licensed professionals. Building departments are essentially the gatekeepers of any construction project.

Building Codes

Building codes protect the public by setting minimum standards and requiring builders to use certain construction standards, including specific methods and materials, sanitary equipment, electrical wiring, and fire prevention techniques. Each state has numerous building codes that builders must follow.
Generally, states have minimum building standards, and local jurisdictions may have stricter standards. Building codes are an example of a government’s police power to enact laws to protect the health, safety, and welfare of the public.

**Building Permits**

Before a construction project can proceed, the building department must approve its specifications and blueprints. Building permits, issued after the approval of the builder’s initial plans, are official documents obtained from the building department that acknowledge that the proposed work meets the department’s standards and grant permission for the construction to take place. Building permits also prompt government authorities to monitor projects and follow up with appropriate inspections.

In some areas, one building permit may cover the entire new construction, building addition, or renovation project. In other areas, however, separate permits may be needed for the building itself as well as the electrical and plumbing systems. In those cases, different inspectors may be utilized.

**Building Inspections**

Building inspection is the process whereby government authorities, usually state or local, are charged with ensuring compliance with prevailing building codes. Since building codes are written to ensure buildings are safe, enforcement of these codes, through inspection, is in the community’s best interest. Inspectors, who can stop work if necessary, may inspect the project several times throughout the construction process to ensure the work is up to code. Inspectors will issue certificate of occupancy after all inspections have been made and the property is deemed fit for occupancy.

Building inspections differ from home inspections in that building inspectors do not inform a prospective buyer of potential problems with a building but ensure compliance with current building standards.

**Subdividing Land**

Subdivision regulations are state and local laws directing how land may be subdivided. These regulations may govern any of the following:

- Size of the lots in a subdivision
- Location and grade of streets and sidewalks
- Easements for sewer, water lines, and other utilities
- Amount of open space and recreational areas

**Demographic Studies**

When a developer proposes to build a subdivision, the planning board researches the impact of the development and ultimately grants or denies the proposal. A critical element of this process is a demographics study to reveal whether the local infrastructure—support facilities and services such as roads, parks, sewers, water, schools, as well as police and fire protection—can sustain the added burden of the proposed development.
The study also provides critical data needed to address **density**, which is **the number of people that can inhabit a parcel of land**. Planning boards regulate a community's density to avoid overcrowding by placing minimum requirements on lot size, boundary requirements, and the size of the dwellings on the lot. The board also determines a property's **setback**, which is **the legal distance that a building must be from a designated position such as a property line**.

**Environmental Impact**

Federal, state, and local governments impose controls to protect the environment, including wildlife, endangered species, and wetlands. Regulations can involve blocking or restricting the use of land where there are environmental concerns. Sometimes this conflicts with a landowner's proposed usage of the land.

Someone seeking approval for a subdivision will likely be required to submit an **environmental impact statement (EIS)**—also called an **environment impact report**—that describes any potential effects that the development could have on air and water quality, solid waste disposal, traffic, noise, water run-off and drainage, school enrollment, energy consumption, wildlife, etc.

**Plats**

A local government enforces subdivision regulations by requiring developers to submit a plat for approval. A **plat depicts the arrangement of buildings, roads, and other services for a development**. Plats can be used in determining traffic patterns in a subdivision, since they illustrate the primary roads, through streets, and cul-de-sacs, which are the dead-end streets that do not connect to main roads.

After a plat has been approved, it is generally recorded in the county in which the land is located. In most cases, only after the plat is recorded can the developer market and sell lots.

**Site Plans**

Site plans are an integral part of any new development project, commercial or residential. Site plans address water sources, soil type, and floodplains; describe how and where buildings and utilities will be situated; and indicate the overall appearance of the new neighborhood. Other considerations include the configuration of streets and sidewalks, zoning in surrounding areas, and the availability of utilities.

A survey is included in the site plan. **Surveys locate and measure the boundaries of a property, and identify improvements, encroachments, and easements associated with the land**.

**Floodplains**

Floodplains are **land areas adjacent to rivers and streams that are subject to recurring flooding**. Because of their continually changing nature, floodplains and other flood-prone areas—particularly **coastal** areas—are analyzed to see how they might affect or be affected by development.

Flood maps are prepared and distributed by the **Federal Emergency Management Agency** (FEMA) for every city and county in the United States. Each FEMA floodplain designation has certain minimum construction requirements that must be incorporated into local building codes. No permit may be issued for construction that does not meet these minimum standards. FEMA makes **periodic inspections** of the local permitting process to monitor **compliance** with construction and permitting standards.
**Floodplain Designations**

There are four principal floodplain designations used to identify the probability of flooding:

- **Zone X** is not considered to be a flood hazard zone. That does not mean the area will never flood. It merely means there is a low probability it will flood.

- **Zone B** identifies the *500-year floodplain*. This means the probability of any property flooding in this zone in any given year is one in 500.

- **Zone A** constitutes the *100-year floodplain*, meaning there is a 1% probability a property located in this zone will flood in *any* given year (1 in 100).

- **Zone V** identifies the *velocity zone*, which extends from offshore to the inland limit of dunes along an open coast, and into river mouths, bays, and estuaries, or any other area subject to high velocity wave action. Properties lying in this zone have the highest probability of flooding and, therefore, must meet strict building codes.

Generally speaking, when a property is located in a designated floodplain, that fact must be disclosed to prospective buyers.

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**Zoning**

*Zoning ordinances* are *laws that divide a city or county into different areas, or zones, to set forth permitted uses and activities under each zoning classification and to specify requirements for compliance*. Zoning ordinances typically have two parts:

1. A zoning *map* that divides the community into designated districts
2. Text of the zoning ordinance that sets forth the type of use permitted in each zone, including specific requirements for compliance

While the state may have some responsibility for determining zoning—mainly for public lands and open spaces—zoning is generally the responsibility of *local entities* such as counties and municipalities.

**Zoning Classifications**

Typical zoning classifications include residential, commercial, industrial, institutional, agricultural, public open space, vacant land, and parkland/recreational. Each classification may also have numerous subcategories. *Residential zones*, for example, are for dwellings and not commercial buildings. Residential zones could include subcategories that allow only single-family homes or multi-family dwellings. There may be a subcategory to allow for a *group home*, which serves the special needs of a group, usually the physically or mentally disabled or those recovering from an addiction or dependency. Orphanages, rehabilitation centers, and halfway houses are all examples of group homes.
Nonresidential Zoning Classifications

Nonresidential zoning classifications may include the following:

- **Commercial.** Businesses such as hotels, offices, retail stores, restaurants, and a host of other entities.
- **Industrial.** Manufacturing facilities and facilities for storing goods, i.e., warehouses.
- **Institutional.** College campuses, correctional facilities, and courthouses.
- **Agricultural.** Areas where animals may graze and crops may be grown.
- **Public Open Space.** Land that is intentionally left undeveloped, such as forests, public parks, lakes, bays, and shorelines (owned either privately or publicly).
- **Parkland/Recreational.** Land specifically used for recreational activities and maintained for their ecological, aesthetic, and educational value.
- **Vacant Land.** Unimproved land (land with no buildings on it) as well as land with buildings that are unoccupied and do not serve a purpose.

Zoning Specifications

Zoning ordinances are generally more specific than simply “Homes go here; businesses go there.” Each zone may define the following:

- Minimum **lot sizes**
- Minimum **front feet** on a road or street
- Maximum **building height** limits, often to comply with local fire codes
- **Setback requirements** and side yard rules that require buildings to be a minimum distance from the front and side property lines
- **Density** of the area, in other words, the ratio of land to improvements or a maximum number of units
- **Buffer zones** or visual barriers to separate and screen residential areas from nonresidential areas
- **Aesthetic elements,** such as landscaping, green space, outdoor lighting, etc.

There may also be a limit on how large a building can be on a specific lot size. For example, a zoning ordinance might indicate that a building can take up only three-fourths of the lot. This is known as **floor area ratio.** Thus, the size of the building is dependent on the size of the lot.

Properties that conform to the zoning ordinances are said to be a legal, conforming use.

Exceptions

Zoning laws are often controversial because they can have a tremendous impact on the use and value of property. A zoning law is constitutional only if it applies in the same manner to all similarly situated property owners. To prevent undue hardships, however, zoning laws usually provide for limited exceptions:
Nonconforming Use
A nonconforming use occurs when land use does not conform to current zoning laws but is legally allowed because the land use was established before the new zoning laws were enacted. This is sometimes called “grandfathered in.” Most nonconforming uses may continue but may not be expanded or enlarged. Generally, permission to continue a nonconforming use is not tied to the landowner. If the property is sold, the new owner may continue the nonconforming use. If, however, the use is abandoned for a statutory period of time, the non-conforming use may be considered expired.

Use Variance
A variance is a form of administrative relief that allows property to be used in a way that does not comply with the literal requirements of the zoning ordinance. There are two types of variances: Use variances and area variances.

Use variances allow landowners to use their land in a way that is not permitted under current zoning laws, such as commercial use in a residential zone. This type of variance is granted only in cases when the current zoning ordinance causes the landowner an unnecessary hardship. To prove unnecessary hardship, owners usually must establish that the requested variance meets these conditions:

1. The landowner is deprived of all economic use and/or benefit of the property and can provide financial evidence to that effect.
2. The landowner did not create the hardship.
3. The hardship is not common to the area or neighborhood.
4. The variance will not change the nature and quality of the neighborhood.

Area Variance
Area variances entitle landowners to use land in a way that is typically not allowed by the dimensional or physical requirements of the zoning law. This type of variance is needed when a building application does not comply with the setback, height, lot, or area requirements of the zoning ordinance, for example. This type of variance is granted only in cases when the current zoning ordinance has practical difficulty affecting the health, safety, or welfare of a community. Landowners must usually demonstrate certain qualifications to obtain an area variance, including:

1. The variance will not create an undesirable change or detriment to neighboring properties.
2. The benefit sought cannot be achieved through other means.
3. The variance is not substantial.
4. The landowner did not create the difficulty.
5. The variance would not have an adverse effect or impact on the physical or environmental conditions in the neighborhood or district.
Conditional Uses

Most zoning laws allow permits to be issued for certain uses that are inconsistent with a neighborhood’s zoning designation but are necessary or beneficial to the community. This situation, known as a conditional use, would generally require a special use permit. These may also be called special exceptions. Common examples of conditional use properties located in residential zones include:

- Fire stations
- Houses of worship
- Hospitals
- Schools
- Cemeteries

A zoning ordinance usually has a specific list of conditional uses that may be allowed in a zone. The zoning board grants permits for these uses, subject to conditions that limit their adverse effects on neighboring property.

Types of Zoning

Some types of zoning are specific to a zoning classification, while others may be applied across the board.

Cluster Zoning

Cluster zoning allows developers to provide a varied selection of lot sizes and housing choices within a single area. A common element to areas with cluster zoning is the incorporation of green spaces, or open spaces, to add to the development’s beauty and for the entire community’s enjoyment. Cluster zoning often takes the form of a planned unit development (PUD), which is a special type of subdivision allowed in some communities that does not comply with all standard zoning and subdivision regulations. For example, a PUD could include detached single-family homes, duplexes, townhouses, or any combination of housing options, as well as a mix of commercial buildings. PUDs maximize land use efficiency by having a high density of housing units combined with the best-planned use of open spaces.

Incentive Zoning

Incentive zoning is a system by which developers receive zoning incentives on the condition that specific physical, social, or cultural benefits are provided to the community. Common incentives include:

- Increases in the permissible number of residential units or gross square footage of the development.
- Waivers of the height, setback, and use provisions of current zoning ordinances.
- Affordable housing, recreational facilities, open space, day-care facilities, and infrastructures.

Spot Zoning

Landowners enjoy the bundle of rights associated with the property they own; “as of right zoning” is implied in this bundle of rights, prohibiting discrimination among landowners in a particular zone. Simply put, if one landowner is permitted, through zoning ordinances, to build a fence on his land, all landowners in that zone are permitted to do the same.
Spot zoning is the illegal rezoning of a single parcel or a small area to benefit one or more property owners rather than carry out the objectives of the master plan. Rezoning is a revision in zoning law, usually changing a zone from one type to another; it is not a variance or exception. Spot zoning is a perfect example of how the rezoning process can be abused if the law is not applied the same way to all property owners.

Enforcing Zoning Ordinances

A zoning board of appeals hears and decides requests for variances and special permits brought before the board. Interpreting zoning laws is also a function of the zoning board of appeals. Zoning ordinances may be enforced in multiple ways:

- Municipalities sometimes establish a zoning certificate system. Before constructing or altering any building, a property owner must first obtain a zoning certificate that is issued only if the building plans, and the proposed use of the property, conform to the zoning laws.
- Use and occupancy permits are documents indicating that an inspector, typically a code enforcement officer, is satisfied that the building is suitable for occupation by meeting appropriate standards for health and safety.
- Building codes are another way to enforce zoning. Recall that building codes are mainly enforced through the building permit system.
- Zoning laws may also be enforced through the courts. If land use decisions are challenged in the courts, experience has shown that the courts tend to uphold decisions made at the local level.

Private Restrictions

Deed restrictions, also known as restrictive covenants, are limitations placed in a deed by a private grantor that restrict the way the land may be used, improved, or maintained. Such restrictions can affect specific deeds or an entire neighborhood. It’s possible that the restrictions prohibit uses that zoning laws would permit.

For Example

A developer may place a restriction on land that only single-family homes may be constructed. Even though zoning in the area supports any type of residential use, the builder has imposed strict control on how the land may be used. And when a deed restriction and zoning law differ, the more restrictive use prevails.

Caution: Licensees should make it a habit to review deeds for their clients to uncover any restrictions that may not have been disclosed prior to entering into a contract. However, they should not offer an opinion about the validity of any restriction. Instead, clients should be advised to consult a real estate attorney if there are any questions about provisions in the deed.

Recording Restrictions

Restrictive covenants run with the land only if they touch and concern the land. They must relate to the use, maintenance, or improvement of the real property. To make a restriction enforceable against third parties, it must be recorded. Once a deed restriction is in the chain of title in the public records, future buyers take title subject to the restriction, even if it is not stated in the deed they receive.
Subdivision CC&Rs

Today, most private restrictions are imposed by developers in a subdivision or condominium community. Restrictions may appear in the deed itself or, more likely, in a separate document that is referenced by the deed called a declaration of covenants, conditions, and restrictions, or CC&Rs. Such restrictions often indicate the type of structures allowed, the setback from the street, the minimum or maximum home size, the materials used in construction, the allowable height of fences, the colors of paint allowed, etc.

Note that subdivision CC&Rs, unlike certain deed restrictions, virtually never require the grantee to forfeit the title to the property. The purpose of CC&Rs is to keep the subdivision attractive and protect the market value of the homes. The lots are mutually burdened and benefited by the restrictions.

Enforcing Restrictions

In the event of a violation, any deed restriction that is reasonable and lawful can generally be enforced by the grantor or other property owners under the same restriction by seeking a court injunction to stop or remove the violation.

If the restriction is not enforced in a timely manner, however, the courts could determine that the right to enforce the restriction is lost. The term that describes this circumstance is laches, the loss of a right through undue delay or a failure to assert.

For Example

A subdivision has a covenant that forbids fences higher than four feet. However, over the years, residents have been quietly ignoring this restriction, and it’s very common to see six-foot fences in the community. A homeowner would probably be safe in assuming that he, too, could put up a six-foot fence, since no action was ever taken to prevent others from putting up a fence higher than allowed.

Homeowners Associations

Homeowners associations (HOAs) are generally formed as nonprofit corporations for the purpose of managing homes (or condominiums) in a residential development. Homeowners usually pay a regular fee (monthly, annually, etc.) to the association for general maintenance and upkeep of the common areas, such as pools, parks, lakes, landscaping, etc.

The duties and powers of the association should be detailed in a homeowners association agreement, which must be signed by the property owners. Most HOAs have the authority to enforce any CC&Rs imposed by the developer on behalf of the whole community or to impose additional rules and regulations. They may be able to levy special assessments against the property owners to cover the expense of improvements to the shared common areas or even impose fines for noncompliance.
Terminating Restrictive Covenants

Restrictive covenants may be terminated in a number of ways, including:

- Setting a termination date
- Releasing the owner from the covenant
- Abandoning the property
- Changing the circumstances of the property and/or the owner

Restrictive covenants that become **illegal after they were written automatically terminate**. For example, a deed restriction indicating people of certain religious beliefs or nationalities may not purchase land may have been legal and enforceable in the past. However, when the Civil Rights Act of 1968 was enacted, religion, national origin, and ancestry became protected classes. These deed restrictions became illegal and were automatically terminated. Any covenant included in a deed restriction today that violates the law would be **unenforceable**.

A Licensee’s Duty of Reasonable Care

While a real estate licensee is not expected to be an expert on the zoning ordinances in a particular community, there is a **due diligence** responsibility to be aware of potential red flags. For example:

- Does a prospective buyer intend to use the property in a way that is different from its current use? If so, would that intended use conform with current zoning requirements?
- Are there pending or proposed changes to local zoning ordinances that might impact the use of the property and, therefore, affect its value?

In a similar vein, it’s important to understand any issues that may arise from deed restrictions or CC&Rs, such as those imposed by a homeowners association. Be aware that most states impose some degree of disclosure when a residential property is subject to HOA restrictions. A responsible licensee will ensure that all required disclosures occur and that any statutory timeframes for review and possible rescission are met.

However, it’s not up to you to interpret zoning, deed restrictions, or any other restrictive covenants. You don’t want to be accused of practicing law! As a licensee, you should be prepared to inform prospective buyers that such restrictions may exist and that they should investigate before making a purchase decision. You should also be prepared to refer clients and customers to attorneys and other qualified experts as necessary and not act outside of the scope of your expertise. Learn to be “the source of the source.”
Environmental Issues

Environmental laws grew out of a concern over the deteriorating quality of the air, land, and water. Federal and state regulations dictate that specific details must be disclosed when potential environmental hazards could be present in and around a property. Thus, it is important to have an awareness of certain critical laws and potential environmental hazards.

The EPA and Environmental Laws

Since its conception in 1970, the federal Environmental Protection Agency (EPA) has established many laws designed to keep the land, air, and water clean and to promote conservation of these natural resources.

| Clean Air Act (CAA) | Requires the EPA to develop air quality standards for existing pollutants, along with establishing air standards for new sources of pollution. |
| Clean Water Act (CWA) | Creates a regulatory structure for the discharge of pollution into waterways. |
| Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) | Addresses what to do with hazardous waste sites; established the Superfund to pay for cleanup. |
| Superfund Amendments and Reauthorization Act (SARA) | Stresses the need and importance of permanent remedies along with the development and use of new treatment technologies for waste-site cleanup. |
| Resource Conservation and Recovery Act (RCRA) | Gives the EPA the authority to control hazardous waste throughout its entire lifecycle, including its generation, transportation, treatment, storage, and disposal. RCRA focuses only on active and future facilities. |

Superfund Sites

The Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA, created mandatory waste-site requirements and established consequences when hazardous materials were released at the sites. The tax revenue, originally from chemical and petroleum industries, goes into a trust fund used for cleaning up large or abandoned hazardous waste sites where no clearly responsible party can be identified. Because of the trust fund, CERCLA is also known as the Superfund. Over the years, the EPA has examined tens of thousands of sites across the country, placing contaminated properties where hazardous waste is located—called Superfund sites—on a National Priorities List.

One common reason a property may be designated as a Superfund site is the presence of an underground storage tank (UST). Underground storage tanks hold a variety of substances such as heating oil, gasoline, chemicals, and hazardous waste. Underground storage tanks can threaten human health and the environment because they may leak, contaminating soil and groundwater.

The EPA has enacted tough standards for USTs, imposing additional steps that owners and property managers must take to protect USTs against corrosion, spills, leaks, and overfills. What was once a common practice for the storage of fuel or chemicals in rural areas, for example, may now be an expensive process of ensuring that tanks do not leak or removing them altogether. This can pose even bigger environmental dilemmas for commercial properties, where costs can be much higher.
Brownfields

The term “brownfields” refers to real properties whose expansion, redevelopment, or reuse may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant. The Brownfields Revitalization Act amended CERCLA in 2002 to provide funds for the cleanup of designated brownfield sites. The legislation also provides guidelines and tax incentives for reinvesting in these old industrial properties to protect the environment, reduce blight, and take development pressures off green spaces and working lands.

Environmental Site Assessments

Under CERCLA, the responsibility for cleaning up contaminated property could be transferred to new owners, which is why potential buyers and lenders conduct a due diligence investigation of the property to determine any potential liability. Only skilled consultants should conduct these studies, called environmental site assessments (ESA). Depending on the findings, an ESA may have multiple phases:

- **Phase I—Investigation.** Property is inspected and records pertaining to the property for a period of 50 years are reviewed. If no problems are found, the process may end here.
- **Phase II—Testing.** Soil, water, air, and building materials are sampled to determine the problem and its severity. If contamination is found, it’s necessary to continue to the next phase.
- **Phase III—Remediation.** At this point, local, state, and federal agencies, and other organizations may participate in the cleanup.
- **Phase IV—Management.** This is an on-going phase that generally includes the management of what was removed from the site as well as routine checks of the site to prevent new problems.

INNOCENT LANDOWNER IMMUNITY The Superfunds Amendments and Reauthorization Act (SARA) created a concept called “innocent landowner immunity.” Current landowners are NOT liable if they did not create the contamination and it was not present on the site when the title was taken, providing there is proof that the buyer followed a process of due diligence, preferably an environmental assessment prior to entering into a contract to buy or lease.

Wetlands

Wetlands are ecosystems where the land is permeated with water. The water either lies on or near the surface of the land. This environment makes it highly conducive to the growth of specific plant life such as reeds, cattails, and mangrove trees. It also creates a habitat for aquatic species and wildlife. Wetlands can vary; in fact, no two wetlands are exactly alike. Wetlands, commonly known as swamps, bogs, and marshes, offer many natural benefits:

- Wetlands help to prevent flood damage by acting as a barrier to dry land and slowing the flow of water that could overwhelm a community.
- They filter groundwater runoff into rivers, lakes, and oceans by trapping sediment that can affect the quality of water and interfere with fish reproduction.
- They provide habitats and nutrient-rich food sources for various wildlife and aquatic species.
Wetlands Protection

Federally, wetlands are protected under sections of the Clean Water Act that deal with the dredging or filling of waters in the United States, including wetlands. It is intended to minimize damage to these important natural habitats. The U.S. Army Corps of Engineers has the responsibility to regulate and enforce these laws, with the EPA having ultimate authority.

In most states, the authority for the protection of wetlands is shared by the state’s environmental protection agency and/or state and local water management agencies. Many activities on wetlands—such as clearing trees or other vegetation; constructing docks, structures, or roads; draining, dredging, or filling; or applying pesticides—may be limited or require permits.

Internal Hazards

Environmental concerns outside the boundaries of a property can have a significant impact on its value. Visible signs of environmental concerns may give buyers a fear of contamination and make a property or neighborhood less valuable. These contaminants include toxic substances in nearby landfills, waterways with high levels of pollution, or thick smog from nearby factories. In addition to such external environmental concerns, other environmental concerns may be present within a specific property.

Asbestos

Asbestos is a fibrous material derived from a naturally occurring group of minerals. In the past, asbestos was commonly found in many building materials because of its insulating, heat-resistant, and fire-resistant properties, for example, cement, ceiling tiles, pipe or ductwork insulation, shingles, and siding.

In its stable state, asbestos poses little to no threat. However, the fibers are easily crumbled and can become powdery when handled, which is known as friable. Once friable, asbestos particles can become airborne, and people can inhale them, trapping them in lung tissue or the digestive tract. Over time, the accumulation causes inflammation and scarring, which, in turn, can lead to a variety of breathing problems and an increased risk for developing many different illnesses, including cancer.

Mitigation

Removal of asbestos-containing materials is the only permanent solution to an asbestos problem. It is, however, an expensive process that must be done by EPA-licensed contractors. There are other methods of managing asbestos without removing it:

- **Encapsulation** is the process of applying a sealant to the asbestos-containing material, which penetrates the material’s surface, preventing the release of the dangerous fibers. However, encapsulating with a penetrating sealant can make future removal of the asbestos-containing material more difficult. Because the encapsulant may begin to deteriorate, it must be regularly inspected.

- **Enclosure** involves isolating asbestos material by using a sturdy, airtight barrier. This is a possible temporary remedy for some asbestos problems.

Since asbestos is thought to be a problem only when it becomes airborne, some believe it is best to simply monitor it and not disturb it if the building materials are in good condition.
Lead

Lead is a metal that was frequently used for pipes and solder of plumbing systems prior to the 1930s. Lead present in water is colorless, odorless, and tasteless. Until 1978, lead was added to both exterior and interior paint as a drying agent and for pigmentation. Unfortunately, research found that digesting or inhaling lead or lead dust causes various health issues. In children, the list of symptoms associated with lead poisoning is extensive. Some early signs of lead poisoning include chronic fatigue or hyperactivity, loss of appetite or weight loss, difficulty sleeping, irritability, and reduced attention span. Adults also face serious dangers from lead poisoning, including fertility problems, high blood pressure, nerve damage, memory loss and concentration problems, muscle and joint pain, and birth defects in their children.

Required Lead Disclosure

Because of the potential exposure to the damaging effects of lead in the home, the federal Residential Lead-based Paint Hazard Reduction Act or Title X was passed in 1992. It requires sellers, real estate licensees, property management companies, sellers, and landlords to disclose known lead paint hazards for homes built prior to 1978:

- Sellers and landlords must disclose any known lead-based paint hazard in homes and must give buyers and tenants any reports available from prior lead tests.
- Seller's agents and landlords must give buyers and renters a pamphlet about how to protect families from lead in homes.
- Homebuyers have a 10-day period (or other mutually agreed on time) to conduct a lead paint inspection or risk assessment.
- Sellers, landlords, and real estate licensees must include certain language in sales contracts and/or leasing agreements to ensure that disclosure and notification take place. This is included in most standard real estate contracts.

Sellers are not required to test for or remove lead paint and/or other lead hazards.

Radon

Radon is naturally occurring radioactive uranium that emanates from rocks, soil, and water as it decays. It is the densest gas known and is odorless, colorless, and tasteless. Since it is radioactive, it has been identified as a cancer-causing agent. Lung cancer is the primary health concern of extended exposure to radon. It may also contribute to other health issues, such as allergies, asthma, hypertension, diabetes, and birth defects.

The presence of radon can vary from location to location, and from house to house. Thus, one house might have a radon problem, while another on the same street might not. The levels within a house can also vary depending on weather conditions and time of year. Radon enters a home from the ground, usually through cracks or holes in the foundation, but can also creep in from uncovered sump pumps and crawl spaces. It can be more of a problem in newer homes, which are built to be more airtight.
Disclosure of Information on Lead-Based Paint and/or Lead-Based Paint Hazards

Lead Warning Statement
Housing built before 1978 may contain lead-based paint. Lead from paint, paint chips, and dust can pose health hazards if not managed properly. Lead exposure is especially harmful to young children and pregnant women. Before renting pre-1978 housing, lessors must disclose the presence of known lead-based paint and/or lead-based paint hazards in the dwelling. lessees must also receive a federally approved pamphlet on lead poisoning prevention.

Lessor’s Disclosure
(a) Presence of lead-based paint and/or lead-based paint hazards (check (i) or (ii) below):
   (i) _____ Known lead-based paint and/or lead-based paint hazards are present in the housing (explain).

   (ii) _____ Lessor has no knowledge of lead-based paint and/or lead-based paint hazards in the housing.

(b) Records and reports available to the lessor (check (i) or (ii) below):
   (i) _____ Lessor has provided the lessee with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing (list documents below).

   (ii) _____ Lessor has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Lessees’s Acknowledgment (initial)
(c) ______ Lessee has received copies of all information listed above.

(d) ______ Lessee has received the pamphlet Protect Your Family from Lead in Your Home.

Agent’s Acknowledgment (initial)
(e) ______ Agent has informed the lessor of the lessor’s obligations under 42 U.S.C. 4852(d) and is aware of his/her responsibility to ensure compliance.

Certification of Accuracy
The following parties have reviewed the information above and certify, to the best of their knowledge, that the information they have provided is true and accurate.

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Abatement

The process of radon gas abatement is relatively inexpensive. In fact, with low levels of radon, simply sealing cracks may be enough to address the problem. With higher levels of radon, it may be necessary to install a radon remediation system, which varies in price and types of systems. It might also be necessary to vent the radon. Radon remediation systems should be installed by an experienced, licensed remediation company.

Carbon Monoxide

Carbon monoxide (CO), a colorless, odorless gas that is the natural byproduct of fuel combustion. Thus, CO may be emitted by appliances such as furnaces, space heaters, fireplaces, water heaters, and stoves. When these appliances function properly, small, regulated amounts of CO are emitted and then dissipate. Unfortunately, if malfunctions occur, unacceptable levels of CO can be released. Larger amounts of CO can also build up when ventilation is inadequate.

Because CO is colorless and odorless, it’s difficult to detect, which makes it especially dangerous. People can experience adverse effects if CO enters the bloodstream because it stops the blood from carrying oxygen throughout the body. Overexposure to CO, or CO poisoning, can cause dizziness, blurred vision, nausea, drowsiness, unconsciousness, and even death.

The most effective method to keep track of CO is with a CO detector. Many states have laws that require homeowners and landlords to install carbon monoxide detectors in buildings that contain bedrooms and sleeping facilities.

Mold

Mold is a fungus that can grow anywhere and on any organic material. Mold requires moisture, oxygen, and a food source. A leaky roof that goes undetected or serious water damage creates a perfect atmosphere for mold growth. New construction, which creates tightly sealed homes, can pose a problem by allowing moisture to remain trapped in the home. If not found in time, mold can consume the substance on which it is growing. Mold can produce allergens, which can trigger reactions such as wheezing, eye and skin irritation, and a stuffy nose. For some people, mold can cause asthma attacks, chronic fatigue, digestive problems, and even neurological problems.

Some molds produce toxic substances known as mycotoxins. One of these types of mold is stachybotrys, or black mold, which is greenish-black in color and grows on materials with high cellulose content such as drywall, ceiling tiles, and wood that is chronically moist. In some situations, mold can even grow behind the surface of walls or wallpaper.

While the EPA has not set standards to measure mold contamination, some states have passed legislation regarding mold issues and disclosure and may require real estate agents to conduct a thorough visual inspection of properties for the existence of mold.

Urea-Formaldehyde Foam Insulation (UFFI)

Urea-formaldehyde is a chemical used in manufacturing, particularly as a resin in building materials such as particleboard, plywood paneling, cabinetry, carpeting, ceiling tile, and insulation. Urea-formaldehyde foam insulation (UFFI) is a type of insulation that can be blown in or injected behind walls and other areas that are hard to access. UFFI was particularly popular in the 1970s and early 1980s.
UFFI and other building materials may emit low levels of formaldehyde gas, resulting in toxic fumes that can cause respiratory ailments when first installed or if poorly installed. Over time, the fumes and release of formaldehyde tend to dissipate. However, if there is a suspicion that urea-formaldehyde foam is present, an expert should be consulted.

Though not specifically banned by federal statute, some states have laws that regulate the use of urea-formaldehyde foam insulation or that require sellers to disclose the presence of UFFI to prospective buyers.

Pests

While not environmental hazards, rodent and insect infestations can cause major physical damage to property. For example, termite problems come in all shapes and sizes. The good news is that most termite infestations are relatively easy to identify by a trained termite technician or home inspector and, if caught in the early stages, are treatable. Major problems result when termite infestations proliferate over several years. This may even threaten the structural integrity of the home. There are numerous preventive measures available to homeowners, the most inexpensive being a competent inspection.

Challenge Activity

*Match the term to the definition.*

A. Area Variance  
B. CC&Rs  
C. Comprehensive Plan  
D. Doctrine of Laches  
E. Nonconforming Use  
F. Police Power  
G. Setback  
H. Spot Zoning  
I. Use Variance  
J. Zoning

___ 1. Declaration of covenants, conditions, and restrictions, usually recorded by a developer to create a plan of private restrictions for a subdivision.

___ 2. Loss of a right through delay or a failure to assert.

___ 3. Allows landowners to use their land in a way that is not permitted under current zoning laws.

___ 4. Constitutional power of state and local governments to enact and enforce laws that protect the public’s health, safety, morals, and general welfare.

___ 5. Legal distance that a building must be from a designated position such as a property line.

___ 6. Government regulation of the uses of property within specified areas.

___ 7. Permit obtained from the local zoning authority allowing the holder to build a structure in a way that legally violates the zoning ordinance.

___ 8. Written document that identifies the goals, principles, policies, and strategies for the growth and development of a community.

___ 9. A rezoning action that favors or restricts a particular property owner without justification.

___ 10. Property use that doesn’t conform to current zoning laws but is allowed because the property was being used that way before the new zoning law was passed.
Summary

1. **Public land use restrictions** include: Zoning, building codes, subdivision rules, and environmental laws. **Zoning laws** separate land use in different areas—they can dictate lot size, building height, setbacks, etc. **Rezoning** is a zoning law change. **Spot zoning** is illegal. Exceptions to zoning laws are **nonconforming uses**, **variances** (*area and use*), and **conditional uses**. **Building codes** set minimum standards for construction and materials. An owner may also have to bring an existing building up to code. **Subdivision regulations** must be complied with (e.g., a **plat** must be approved and recorded) before land can be subdivided.

2. **Private restrictions** are conditions or covenants. **Restrictive covenants** relate to use of property and may run with the land. Developers can impose restrictions on a subdivision by recording **CC&Rs**.

3. **Environmental laws** include: Clean Air Act, Clean Water Act, Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), and Superfund Amendments and Reauthorization Act (SARA).

4. **Wetlands** are ecosystems where the land is permeated with water, which either lies on or near the surface of the land. Benefits include preventing flood damage, acting as a natural filtration system, and providing habitats for various wildlife and aquatic species. State agencies also have the authority to protect the wetlands by limiting activities or requiring permits.

5. Environmental concerns within a property can be dangerous, but sometimes can be rectified. Sellers are usually required to disclose known hazards on some type of residential property disclosure form. For houses built **before 1978**, the **lead-based paint** brochure must be given to buyers and potential tenants, known lead paint hazards must be disclosed, and buyers must be given a 10-day period to conduct lead tests.

6. **Asbestos** is a heat resistant material once used as insulation but now determined to cause cancer. **Urea-formaldehyde foam** is a blown-insulation that can emit toxic fumes. **Radon gas** is a naturally occurring radioactive gas that can get into homes through cracks and build up to dangerous levels if not prevented. **Underground storage tanks** require steps to stop corrosion, spills, leaks, and overfill. **Mold** is a fungus that can grow anywhere and on any organic material.
Chapter Quiz

1. The state and local government’s authority to enact and enforce laws that protect the public’s health, safety, morals, and general welfare is known as
   A. constitutional authorization.
   B. general interest license.
   C. police power.
   D. safety mandate.

2. The concept of escheat means that property
   A. can be appropriated by the state when there’s a public need.
   B. can be confiscated for nonpayment of taxes.
   C. must meet specific zoning requirements before it can be developed.
   D. reverts to the state when a person dies without a will, an heir, or a creditor.

3. The government sends you a notice stating that the houses on your road will be demolished to build a new landfill. You are paid fairly for your home and move. The act of demolishing your home is
   A. adverse possession.
   B. condemnation.
   C. eminent domain.
   D. encroachment.

4. The government sends K a notice stating that his house and neighborhood will be demolished to build a much-needed water treatment plant. What is the government required to offer K in exchange for condemning his property?
   A. just compensation
   B. nothing, since it is for the public good
   C. whatever K asks for
   D. whatever they decide is reasonable

5. Which of these is NOT an example of police powers?
   A. declaring a stretch of river a scenic waterway, thus preventing development
   B. putting zoning laws in place to prohibit nude dance clubs within a mile of a school
   C. requiring all homes with livable basement areas to have an escape window
   D. taking property to build a highway through eminent domain

6. What is a written document created by a planning board that identifies goals, objectives, principles, guidelines, policies, standards, and strategies for the growth and development of a community?
   A. master plan
   B. plat
   C. variance
   D. zoning map

7. Building codes are primarily enforced by
   A. the granting of licenses.
   B. the issuance of permits.
   C. letters of approval.
   D. zoning laws.

8. Of these, which is LEAST LIKELY to be considered a conditional use in an area zoned as residential?
   A. cemetery
   B. gas station
   C. hospital
   D. school

9. A disabled man with a wheelchair wants to install a ramp on the side of his house so he can easily get from his car into his kitchen. The ramp would be too close to the property line based on the current zoning ordinance. He must go to the zoning board to obtain a/an
   A. area variance.
   B. grandfather clause.
   C. nonconforming use.
   D. use variance.
10. F owns a gas station on the edge of town. As the town grows, more homes are built and the area where his gas station is gets rezoned residential. What specific exception would allow F to continue operating the gas station?
   A. area variance
   B. conditional use
   C. nonconforming use
   D. special exception

11. T buys a parcel of land and goes to the local zoning officer before he builds his house to see what restrictions he might have to consider. Which is LEAST LIKELY to be addressed by a zoning ordinance?
   A. the number of outlets required for each room
   B. the position of the building on the lot
   C. the size of the structure
   D. whether or not T can operate a bar from the property

12. S buys a parcel on the edge of a suburb where several new subdivisions are being developed and begins to save money to build a café. When she is ready to build, she finds out that the area is zoned residential. What can she do?
   A. request a special exception
   B. request a use variance
   C. request spot zoning
   D. request to be grandfathered in

13. A condominium development has a deed restriction about flying flags. Several residents violate the restriction, but no one complains until someone flies the flag of the rival college football team on game day. The neighborhood association may not be able to enforce this deed restriction because of
   A. appropriation.
   B. escheat.
   C. laches.
   D. reversion.

14. The rezoning of a single parcel of land or a small area to benefit one or more property owners rather than carry out objectives of the master plan is
   A. as of right zoning.
   B. cluster zoning.
   C. incentive zoning.
   D. spot zoning.

15. Which is NOT a reasonable deed restriction?
   A. indicating the types of buildings that may be constructed
   B. limiting activities that can be conducted at the site
   C. listing religions of purchasers who would be acceptable
   D. requiring a minimum size for buildings being constructed

16. Which federal environmental law creates requirements for closed and abandoned waste sites and sets up the Superfund?
   A. CAA
   B. CERCLA
   C. RCRA
   D. SARA

17. Title X requires real estate licensees to disclose known lead paint hazards for homes built before
   A. 1959.
   B. 1964.
   C. 1978.
   D. 1986.

18. Friable asbestos particles are dangerous when
   A. encapsulated.
   B. inhaled.
   C. touched.
   D. wet.
19. ABC Corp. is selling a parcel of land that was once the site of a factory to XYZ Inc. Who is responsible for determining whether there are any environmental hazards on the property?
   A. ABC Corp.
   B. the county where the property is located
   C. the Environmental Protection Agency
   D. XYZ Inc.

20. What is the final phase in a CERCLA Environmental Site Assessment?
   A. investigation
   B. management
   C. remediation
   D. testing
You have been gaining the tools necessary to help clients list, sell, and buy real estate. This chapter examines the end of the process: Real estate closing, also known as settlement. Closing results in the transfer of real property ownership from seller to buyer, according to the terms of the purchase agreement.

We’ll begin with a discussion of the federal Real Estate Settlement Procedures Act (RESPA). Then, we’ll walk through the closing process so you can get an idea of the people and documents involved, particularly the standard Closing Disclosure. Finally, we’ll identify some of the most common costs associated with closing a real estate transaction and work through some closing-related calculations.

After reading this chapter, you will be able to:
- Recall provisions of the federal Real Estate Settlement Procedures Act (RESPA).
- Identify the steps, documentation, and parties involved in a real estate transaction settlement.
- Discuss closing costs and perform proration and transfer tax calculations.

**Key Terms**

Accrued Expense  
Affiliated Business Arrangement (AfBA)  
Closing  
Closing Disclosure  
Credit  
Debit  
Discharge of Mortgage  
Escrow Closing  

Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)  
Home Warranty  
IRS Form  
Kickback  
P.O.C.  
Prepaid Expenses  
Proration  

Real Estate Settlement Procedures Act (RESPA)  
Recording Fees  
Roundtable Closing  
Settlement Officer  
Settlement Services  
Statutory Year  
Title Insurance  
Transfer Tax
Real Estate Settlement Procedures Act (RESPA)

To review, the federal Real Estate Settlement Procedures Act, which is implemented by Regulation X, was enacted to ensure that consumers receive the actual costs associated with closing a transaction and to protect consumers from predatory lending practices. RESPA requirements apply when a purchase of a one-to-four-family house is financed by a federally related mortgage loan (banks and credit unions, loans insured by FHA and loans guaranteed by the VA). RESPA does not apply to loans for:

- Vacant land
- Properties of 25 acres or more
- Temporary financing, such as construction loans

RESPA is administered and enforced by the Consumer Financial Protection Bureau (CFPB). Violators can face the following criminal and civil penalties:

- Fines up to $10,000
- Imprisonment up to one year
- Liability up to three times the amount paid for the service (in a civil lawsuit)

Settlement Services

RESPA defines settlement services as any service provided in connection with a prospective or actual settlement. Such services include:

- Services by a real estate broker to make sure that transaction details have been taken care of so that the closing proceeds smoothly
- Any services related to the origination, processing, underwriting, or funding of a mortgage loan, including service by a mortgage broker
- Title services, including title searches, title examinations, abstract preparation, insurability determinations, and the issuance of title commitments and title insurance policies
- Services by an attorney, which may include the review and modification of applicable documents and contracts
- Preparation of documents, including notarization, delivery, and recordation
- Rendering of credit reports and appraisals
- Inspections that are part of the sales agreement or mortgage documents prior to transfer of title
- Conducting of settlement by a settlement agent and any related services
- Services involving mortgage, hazard, flood, or other casualty insurance or home warranties
- Services involving real property taxes or any other assessments or charges on the real property
- Any other services for which a settlement service provider requires a borrower or seller to pay
Prohibitions and Limitations

Consumers have the right to choose the settlement service provider they prefer. RESPA protects that right by prohibiting brokerages from requiring their clients to use a specific company, although there are some exceptions for lenders. RESPA provides several other guidelines to protect consumers, too.

Discounts or Rebates

It is acceptable for a services provider to offer a package of services at a discount or rebate to consumers as long as:

- The services are not considered a “required use.”
- The package discount or rebate is optional.
- The discount is a true discount below prices that are otherwise generally available.
- The discount cannot be made up by higher costs elsewhere in the settlement process.

Kickbacks

Section 8 prohibits settlement service providers from giving or accepting a fee, kickback, or anything of value in exchange for referrals of settlement service business. A referral is any oral or written action directed to a person that has the effect of affirmatively influencing the selection of a provider of a settlement service or business. RESPA defines a “thing of value” very broadly, and it can include any of the following:

- Money, things, discounts, trips, and payment of another person’s expenses
- Salaries, commissions, earnings, fees, or distribution of partnership profits or franchise royalties
- Credits representing money paid at a future date or the opportunity to participate in a money-making program
- Special bank deposits or accounts, special or unusual banking terms
- Services, sales, or leases of all types at special or free rates
- Lease or rental payments based in whole or in part on the amount of business referred
- Reduction in credit against an existing obligation

A thing of value does not include things of minimal value used for promotional purposes, such as pens, mementos, coffee cups, hats, etc.

Fee-Splitting and Unearned Fees

Section 8 also prohibits fee-splitting and receiving unearned fees or a percentage of any charge made or received for services not actually performed. The following payments, however, are allowed:

- Payment of fees to attorneys, title companies, or agents for services performed
- Payment of a bona fide salary or compensation to a person for goods or products furnished or services performed in the making of a loan
- Payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers
- An employer’s payment to its own employees for any referral activities
**Specific Settlement Services Providers**

Section 9 prohibits a seller or other party to the transaction from requiring the homebuyer to use a specific settlement service provider, either directly or indirectly, as a condition of sale. Buyers may sue a seller who violates this “required use” provision for an amount equal to three times all charges made for the title insurance.

**Escrow Accounts**

Section 10 limits the amount a lender may require a borrower to put into an escrow account. An escrow account holds money—usually for purposes of paying taxes, hazard insurance, and other charges related to the property—that some mortgage lenders collect every month along with a mortgage payment. RESPA does not require lenders to impose an escrow account on borrowers; however, certain government loan programs or lenders may require escrow accounts as a condition of the loan.

**Affiliated Business Arrangements (AfBAs)**

While kickbacks from referrals are prohibited, RESPA does recognize the legitimacy of affiliated business arrangements involving real estate settlement services. An affiliated business arrangement, or AfBA, is a situation where a person or entity in a position to refer settlement services has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1% in a provider of settlement services. Under RESPA, it is acceptable for this person, or an associate of this person, to refer business to that provider or in some way influence the selection of that provider if they provide proper disclosure.

**AfBA Disclosure**

Whenever a settlement service provider involved in a RESPA covered transaction refers the consumer to a provider with whom the referring party has an ownership or other beneficial interest, that relationship must be disclosed. The referring party must give consumers an AfBA disclosure at or prior to the time of referral. The disclosure must describe the business arrangement that exists between the two providers and give the borrower an estimate of the referred provider's charges. The following message should also be conveyed:

“There are frequently other settlement service providers available with similar services. You are free to shop around to determine that you are receiving the best services and the best rate for these services.”

Except in cases where a lender refers a borrower to an attorney, credit reporting agency, or real estate appraiser to represent the lender's interest in the transaction, the referring party may not require the consumer to use the particular provider being referred.
Real Estate Closing

A closing, also referred to as settlement or loan consummation, is the final step in a real estate transaction when the transfer of real property ownership from seller to buyer occurs in exchange for payment of the agreed purchase price, according to the terms and conditions in a sales contract. In most real estate transactions, two closings simultaneously take place:

- The closing of the buyer’s mortgage loan and disbursement of the funds.
- The closing of the sale and transfer of title.

Before a real estate transaction closes, all conditions and contingencies to the purchase agreement must be met.

Even though licensees are rarely responsible for conducting the closing, a licensee fulfills the obligations of care and accountability by ensuring the closing transaction follows the terms as outlined in the written purchase agreement. In some areas, it is customary for licensees to step out of the picture once they have brought about a meeting of the minds, turning everything over to attorneys for the seller and buyer. In other areas, licensees remain involved all the way through closing, assisting and informing the client, and remaining in contact with all parties to ensure everything necessary to close the transaction is in place.

Regardless of the extent of the licensee’s participation, any earned commission is paid at the closing. Prior to the closing, the listing broker submits a commission statement to the participating attorneys or settlement officer, and a check is cut to the listing broker for commission earned. The broker is then responsible for distributing the commission to his licensees. In some areas, the listing broker pays any cooperating brokerages as per their agreement. In other areas, the settlement officer will cut a check to each participating brokerage.

Settlement Officer

Escrow can be thought of as a clearinghouse in which title is closed using a neutral third party to hold documents and money while carrying out the instructions of the purchase agreement. The settlement officer—sometimes called a closing officer, an escrow agent, or a title agent—is generally the person responsible for conducting closing proceedings. The settlement officer might prepare the settlement statement, which involves documenting the costs associated with the transaction and calculating the division of credits and debits between the buyer and the seller. This is also the person who will collect and disburse all funds to the appropriate parties. A settlement officer is most commonly one of the following:

- A representative from the lender,
- An employee of a title company, or
- The buyer’s or seller’s attorney.

The purchase agreement typically identifies when, where, and how the closing takes place. The key with scheduling any closing is that it must occur by the closing date stated in the purchase agreement or within a reasonable amount of time if no date is specified. Sometimes, a separate escrow instructions document might be used to communicate the closing details.
Paying Liens

Generally, the settlement officer's first task is to order a preliminary title report, prepared by the title company, to find all liens, which are financial encumbrances. The owner customarily removes all liens from the property prior to the sale. If a lien isn't removed or satisfied before the closing date, for example, delinquent taxes or homeowners association dues, the liens must be paid off at closing with proceeds the seller receives from the buyer.

If the seller has mortgage liens, IRS tax liens, or any other liens, he will have to obtain a payoff statement for each lien. If the buyer is assuming the seller's mortgage, then the buyer should get a mortgage reduction certificate from the lender, which will list the exact amount of the balance as of the closing date, the interest rate, and the date of the last payment.

Closing Participants

Closings may be conducted in escrow or roundtable. An escrow closing is handled by a disinterested third party and is usually not attended by the buyer and seller. A roundtable closing is a face-to-face meeting of all interested parties, generally held at the title company, the broker's office, the lending institution, or a participating attorney's office. Regardless of the type of closing, each participant has a distinct role:

- **Buyers** pay for and receive title to the property.
- **Sellers** grant their property to the buyers and receive payment for it.
- The **buyer's and seller's attorneys** review all closing documents to ensure they are in their clients' best interests.
- **Real estate brokers** receive any earned commission and fulfill their obligation to account for all monies.
- A **lender representative** examines all loan documents, verifies the property for which a mortgage is being issued has clear title, and disburses funds to the seller.
- A **title company representative** reviews the documents and, once satisfied, delivers evidence that the title is insured.

A buyer or seller who cannot attend a roundtable closing may use the power of attorney to appoint someone to handle her part in the transaction.

Double Escrow/Simultaneous Closing

A double escrow, also known as a simultaneous close, is a situation in which a property is sold, and then is immediately sold again once the first transaction closes. This is considered a type of wholesale deal, where an investor acts as a middleman between seller and ultimate buyer.

For example, an investor closes on the purchase of a property for $100,000. This is the first escrow. The investor then sells the property to someone else on the same day for $110,000. This is the second escrow. After all closing costs are paid, the investor keeps the difference. The double escrow is most closely associated with flipping distressed properties. While not illegal in most states, it's likely that such transactions must be disclosed.

A double escrow scenario may not be possible for certain property transactions. For example, HUD has a policy that requires a certain amount of “seasoning between transactions.” So purchases using FHA-insured loans or VA-guaranteed loans could not have a simultaneous close.
Common Closing Documents

One of the most important documents necessary to prepare for a real estate closing is the purchase agreement between the seller and the buyer. The terms of the purchase agreement dictate the requirements of the closing, including the necessary documents. For example, if the transaction involves the transfer of personal property from the seller to the buyer, a bill of sale may be required. While not every document is applicable for every closing, several documents or forms are typically presented and reviewed as part of the closing process.

Evidence of Title

A title company is generally responsible for examining and researching title to the property, ensuring that it is indeed transferrable. Evidence of title is generally in the form of title insurance, which is an insurance policy that protects the policyholder against loss or damages from defects in the title. A lender will require title insurance, called a mortgagee policy. Buyers may purchase title insurance if they choose. Evidence of title could also be found in a title report, which is a document stating the current title status of the property.

An affidavit of title (also referred to as a vendor’s affidavit) is a statement, sworn in front of a notary public or other authorized official, by the seller or grantor of property that identifies the grantor, identifies the grantor’s marital status, and certifies that the grantor has no new judgments, liens, divorces, unrecorded deeds, or other potential title defects since the title examination was completed. It also certifies that the grantor is indeed in possession of the property and that no tenants reside on the property.

A continuation, or bring-down endorsement, is a title search performed just prior to settlement to bring a preliminary title report up to date and ensure that no intervening rights to the property have come up. The affidavit of title may serve this purpose if required.

Deed

A deed is an instrument that conveys a grantor’s interest, if any, in real property. At closing, the seller (the grantor) provides a new, signed deed to the buyer (the grantee). To be properly executed, the grantor must deliver the deed with the intention of transferring title. Once the grantee accepts the deed, he holds title to the land.

Mortgage Documentation

Most financed real estate transactions require these documents:

- The financing instrument, typically a promissory note, is a written promise to repay the money owed. The lender brings the note to closing, and the borrower signs it.
- The security instrument, usually a mortgage or deed of trust, provides security for the debt by creating a voluntary lien against the property. The buyer is required to sign this and give it to the lender as security for repayment of the note.

If the seller still has a mortgage on the property, the buyer's lender typically brings a check in the payoff amount made out to the seller's mortgagee or to the title company or closing agent, who in turn writes checks to all the parties to the transaction as appropriate. Once the seller's lender is paid, the lender issues a mortgage release document, referred to as a satisfaction of mortgage or discharge of mortgage, which should be recorded as evidence that the lien has been released.
Other Documentation

Other documentation seen at closing might include the following:

- **Survey.** In some transactions, either the buyer or the buyer's lender will require a survey to ensure the property description is accurate. A survey documents the physical size and boundaries of a property. If the mortgage lender requires a survey, the buyer usually bears the cost of it, although this may be dependent on local custom and is certainly open to negotiation.

- **Insurance Policies.** Lenders require evidence of homeowner's insurance policies, also known as hazard insurance, that are sufficient to replace the home or reimburse the mortgage amount in the event of a fire or other disaster. Depending on the location of the property, flood insurance may also be required.

- **Inspections.** Lenders require a pest inspection, while buyers may also require a home inspection. Other inspections that could be required by a buyer or lender include structural integrity, septic systems/soil/waterflow (referred to as percolation or perc tests), and radon gas, among others. Some municipalities may require a certificate of occupancy as evidence that the property is habitable in addition to property inspections.

- **IRS Form 1099-S.** For sales or exchanges of certain real estate, the settlement officer must report the seller's proceeds to the Internal Revenue Service using IRS Form 1099-S. Information on this form includes the seller's name, Social Security number, and the sale price of the property. Generally, this is a requirement only for title transfers involving the sale of principal residences with gross sales prices above $500,000 for sellers who are married couples, or above $250,000 for sellers who are single taxpayers. Many settlement officers choose to submit this report for every transaction.

- **FIRPTA Forms.** The Foreign Investment in Real Property Tax Act of 1980 imposes income tax on foreign persons selling or otherwise disposing of their interest in real property. To ensure payment of this tax, the Internal Revenue Service requires buyers to withhold a specific percentage of the sales price, with some exceptions.

- **Home Warranties.** A home warranty covers the repair or replacement of specified components of the home, for example, heating and air conditioning, plumbing and electrical systems, and appliances such as stoves, refrigerators, dishwashers, washers and dryers, microwave ovens, and garbage disposals. Coverage extends for the specified period of time, often one year. Builders generally provide buyers with home warranties on newly constructed homes, the terms of which may be mandated by state law. Sellers may choose to offer home warranties to buyers as an incentive to purchase. If the seller already has a home warranty in place, the remaining period generally transfers to the new owner at closing. If the seller does not offer a home warranty, buyers may choose to purchase one themselves. Local custom, however, often dictates which party pays for a home warranty.

Closing Costs

Settlement is about the exchange of funds for title to property. There are many costs associated with a real estate transfer, and a balance sheet must be created that specifically indicates who owes what and who is due what, in other words, debits and credits. Much like a property's listing price, many of these closing costs are negotiable.
The responsibility for paying these typical closing costs often depends on local customs or state law. Make sure you understand how closings costs are handled in the jurisdictions in which you practice.

**Typical Buyer Costs**

The costs buyers can expect to pay include the following:

- **Appraisal, credit report, and survey fees**, typically charged to buyers by lenders as part of the mortgage application process
- **Attorney's fees** for legal representation
- **Loan fees**, which can be a variety of charges payable to the lender upon closing:
  - **Origination fee** to compensate the lender for making the loan
  - **Points** paid to a lender to lower the interest rate, to accommodate a higher risk borrower or a higher risk property, or to meet other obligations.
  - **Escrow reserves** to pay for hazard insurance and property taxes
  - **Tax service fees** to offset the cost of monitoring the escrow account for property taxes
  - **Private mortgage insurance** (PMI) if the loan-to-value on a conventional loan is greater than 80%; **mortgage insurance premium** (MIP) for an FHA-insured loan; or a **funding fee** for a VA-guaranteed loan
  - **Condo or co-op fees**, which the buyer may owe to adjust for assessments paid by the seller for services the buyer will use
  - **Home and termite inspection fees**
  - **Recording fees** paid to the county clerk for filing the deed, mortgage, and any other recorded documents
  - **Title insurance**, required by lenders to ensure a good, marketable title
  - **Flood certification fee**, required to analyze whether property is in a flood zone and therefore requires flood insurance

**Typical Seller Costs**

The costs sellers can expect to pay include the following:

- **Attorney fees**, which vary depending on the type of representation provided and the amount of work involved
- **Broker's commission**, which is typically a percentage of the property's sale price
- **Condo, co-op, homeowners association fees**, which are assessments for maintenance of common areas and other items; before closing, sellers generally must bring their account current
- **Title search** charges
- **Existing lien payments**, if there are any on the property, are generally satisfied prior to close, although it is not a legal requirement; e.g., in a cash transaction, the buyer has the right to purchase the property subject to outstanding liens
- **Recording fees** if sellers have file a discharge of mortgage and/or other satisfaction of judgments through attorneys; the recording fee varies by jurisdiction
- **Home warranty fee**, if the seller chooses to offer one
Transfer Tax

Sellers are also usually required to pay a real estate transfer tax, which is simply a tax on the value of real property when it is sold. Transfer tax may be imposed by the state, the county, and perhaps the municipality in which the property is located.

The tax is typically collected by the recorder or registrar of titles of the county in which the property is situated through the sale of transfer tax stamps. These revenue stamps must be affixed to the deed or other document conveying title before the deed can be recorded. A declaration that identifies the property being transferred and includes its value generally accompanies the deed. The declaration is signed by at least one of the sellers and one of the buyers (or their attorneys or agents).

Most jurisdictions base the tax on the full purchase price of the property, often stated as an amount of money per each $1,000 of transaction value or fraction thereof.

For Example

Let’s say the total transfer tax in the state is 75 cents on every $1,000 of transaction value or fraction thereof. A house sells for $267,300. To determine the transfer tax the seller owes, first calculate how many thousand-dollar units there are:

\[
\frac{\text{purchase price}}{\text{$1,000}} = \frac{267,300}{1,000} = 267.3 \text{ units}
\]

That .3 indicates there is an additional fraction of $1,000, so it’s necessary to add 1 unit for a total of 268 units. Now simply multiply the number of units by the tax rate to determine the transfer tax:

\[
268 \text{ units} \times 0.75 = 201 \text{ transfer tax to the state}
\]

Note: This is just one example of how transfer tax may be handled. Make sure you understand the process in the jurisdictions in which you practice.

<table>
<thead>
<tr>
<th>Closing Cost</th>
<th>Buyer Pays</th>
<th>Seller Pays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraisal</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Credit report</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Attorney</td>
<td>X-as negotiated</td>
<td>X-as negotiated</td>
</tr>
<tr>
<td>Broker commission</td>
<td>X-as negotiated</td>
<td>X-as negotiated</td>
</tr>
<tr>
<td>Existing liens</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Flood certification</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Home inspection</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Home warranty</td>
<td>X-as negotiated</td>
<td>X-as negotiated</td>
</tr>
<tr>
<td>Loan</td>
<td>X-new mortgage fees, escrow</td>
<td>X-existing mortgage</td>
</tr>
<tr>
<td>Recording</td>
<td>X-new mortgage, deed</td>
<td>X-satisfaction of mortgage/liens</td>
</tr>
<tr>
<td>Survey</td>
<td>X-if required by lender</td>
<td></td>
</tr>
<tr>
<td>Title</td>
<td>X-title insurance</td>
<td>X-title search</td>
</tr>
<tr>
<td>Transfer tax</td>
<td></td>
<td>X-as required</td>
</tr>
</tbody>
</table>
Debits and Credits

To understand the final amount of money that a buyer will have to pay or a seller will receive at the closing, it's important to understand the concept of debits and credits.

- **Debits** (like debts) are any sum of money that is owed. A debit is charged to a party on a balance sheet to represent money that must be paid to the other party at the moment of closing.

- **Credits** are any sum of money to be received. A credit is given to a party on a balance sheet to represent money that should be paid by the other party at the moment of closing.

Debits and credits work together to reconcile the settlement statement. All debits owed by the buyer are totaled and added to the purchase price. Then the credits are totaled and subtracted from the total debits to determine how much money the buyer must bring to closing.

For example, a mortgage loan amount shows up as a credit to the buyer, since it is actually the lender who brings that money to closing. If the buyer assumes the seller's loan, they are only assuming the current balance, so this too is a credit because this is cash that they don't have to bring to close. The details on a settlement statement allow a buyer to see the acquisition cost, which is a total of the amount of money necessary to purchase the property, since it shows the sales price as well as the charges necessary to close the loan.

A similar process occurs on the seller's side. All credits due to the seller are totaled and added to the purchase price. All debits owed by the seller are totaled and subtracted from the total money due to determine how much money the seller will receive at the closing.

The Closing Disclosure

A settlement statement is the balance sheet that itemizes all expenses and costs paid by the buyer and seller to close the real estate transaction, including loan origination costs and all sales commissions. The statement also includes charges the buyer or seller will pay at settlement, as well as charges they paid outside of settlement. For each settlement service, the statement must show the name of the person who receives payment and the total amount paid.

All RESPA-related transactions must use a standardized settlement statement, known as the Closing Disclosure. This document, defined under the TILA-RESPA Integrated Disclosure (TRID) rule, replaces the HUD-1 Settlement Statement that was standard for real estate transactions for decades.
Real Estate Principles and Practices

## Closing Disclosure

This form is a statement of final loan terms and closing costs. Compare this document with your Loan Estimate.

<table>
<thead>
<tr>
<th>Closing Information</th>
<th>Transaction Information</th>
<th>Loan Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date Issued</td>
<td>Borrower</td>
<td>Loan Term</td>
</tr>
<tr>
<td>4/15/2013</td>
<td>Michael Jones and Mary Stone</td>
<td>30 years</td>
</tr>
<tr>
<td>Closing Date</td>
<td>123 Anywhere Street</td>
<td>Purpose</td>
</tr>
<tr>
<td>4/15/2013</td>
<td>Anytown, ST 12345</td>
<td>Purchase</td>
</tr>
<tr>
<td>Settlement Agent</td>
<td>Seller</td>
<td>Product</td>
</tr>
<tr>
<td>Epsilon Title Co.</td>
<td>Steve Cole and Amy Doe</td>
<td>Fixed Rate</td>
</tr>
<tr>
<td>File #</td>
<td>321 Somewhere Drive</td>
<td></td>
</tr>
<tr>
<td>12-3456</td>
<td>Anytown, ST 12345</td>
<td>Loan Type</td>
</tr>
<tr>
<td>Property</td>
<td>Lender</td>
<td>Conventional</td>
</tr>
<tr>
<td>456 Somewhere Ave</td>
<td>Ficus Bank</td>
<td>VA</td>
</tr>
<tr>
<td>Anytown, ST 12345</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale Price</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$180,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## Loan Terms

<table>
<thead>
<tr>
<th>Loan Amount</th>
<th>$162,000</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Rate</td>
<td>3.875%</td>
<td>NO</td>
</tr>
<tr>
<td>Monthly Principal &amp; Interest</td>
<td>$761.78</td>
<td>NO</td>
</tr>
</tbody>
</table>

### Does the loan have these features?

- Prepayment Penalty: YES • As high as $3,240 if you pay off the loan during the first 2 years
- Balloon Payment: NO

## Projected Payments

<table>
<thead>
<tr>
<th>Payment Calculation</th>
<th>Years 1-7</th>
<th>Years 8-30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal &amp; Interest</td>
<td>$761.78</td>
<td>$761.78</td>
</tr>
<tr>
<td>Mortgage Insurance</td>
<td>+ 82.35</td>
<td>+ —</td>
</tr>
<tr>
<td>Estimated Escrow</td>
<td>+ 206.13</td>
<td>+ 206.13</td>
</tr>
</tbody>
</table>

**Estimated Total Monthly Payment:**

- Years 1-7: $1,050.26
- Years 8-30: $967.91

**Estimated Taxes, Insurance & Assessments:**

- Amount can increase over time
- $356.13 a month

This estimate includes:

- Property Taxes: YES
- Homeowner’s Insurance: YES
- Other: Homeowner’s Association Dues: NO

See Escrow Account on page 4 for details. You must pay for other property costs separately.

## Costs at Closing

- **Closing Costs:** $9,712.10
  - Includes $4,694.05 in Loan Costs + $5,018.05 in Other Costs – $0 in Lender Credits. See page 2 for details.
- **Cash to Close:** $14,147.26
  - Includes Closing Costs. See Calculating Cash to Close on page 3 for details.
# Closing Cost Details

## Loan Costs

<table>
<thead>
<tr>
<th>A. Origination Charges</th>
<th>Borrower-Paid</th>
<th>Seller-Paid</th>
<th>Paid by Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Closing</td>
<td>Before Closing</td>
<td>At Closing</td>
<td>Before Closing</td>
</tr>
<tr>
<td>1. 25% of Loan Amount (Points)</td>
<td>$405.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Application Fee</td>
<td>$300.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Underwriting Fee</td>
<td>$1,097.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>6.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Services Borrower Did Not Shop For</th>
<th>Borrower-Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Closing Before Closing</td>
<td></td>
</tr>
<tr>
<td>1. Appraisal Fee to John Smith Appraisers Inc.</td>
<td>$405.00</td>
</tr>
<tr>
<td>2. Credit Report Fee to Information Inc.</td>
<td>$29.80</td>
</tr>
<tr>
<td>3. Flood Determination Fee to Info Co.</td>
<td>$20.00</td>
</tr>
<tr>
<td>4. Flood Monitoring Fee to Info Co.</td>
<td>$31.75</td>
</tr>
<tr>
<td>5. Tax Monitoring Fee to Info Co.</td>
<td>$75.00</td>
</tr>
<tr>
<td>6. Tax Status Research Fee to Info Co.</td>
<td>$80.00</td>
</tr>
<tr>
<td>7.</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>C. Services Borrower Did Shop For</th>
<th>Borrower-Paid</th>
</tr>
</thead>
<tbody>
<tr>
<td>At Closing Before Closing</td>
<td></td>
</tr>
<tr>
<td>1. Pest Inspection Fee to Pests Co.</td>
<td>$120.50</td>
</tr>
<tr>
<td>2. Survey Fee to Surveys Co.</td>
<td>$85.00</td>
</tr>
<tr>
<td>3. Title – Insurance Binder to Epsilon Title Co.</td>
<td>$650.00</td>
</tr>
<tr>
<td>4. Title – Lender’s Title Insurance to Epsilon Title Co.</td>
<td>$500.00</td>
</tr>
<tr>
<td>5. Title – Settlement Agent Fee to Epsilon Title Co.</td>
<td>$500.00</td>
</tr>
<tr>
<td>6. Title – Title Search to Epsilon Title Co.</td>
<td>$800.00</td>
</tr>
<tr>
<td>7.</td>
<td></td>
</tr>
<tr>
<td>8.</td>
<td></td>
</tr>
</tbody>
</table>

| D. TOTAL LOAN COSTS (Borrower-Paid) | $4,694.05 |
| Loan Costs Subtotals (A + B + C) | $4,664.25 | $29.80 |

## Other Costs

<table>
<thead>
<tr>
<th>E. Taxes and Other Government Fees</th>
<th>$85.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Recording Fees to Any State</td>
<td>$85.00</td>
</tr>
<tr>
<td>2. Transfer Taxes to Any State</td>
<td>$950.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>F. Prepays</th>
<th>$2,120.80</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Homeowner’s Insurance Premium (12 mo.) to Insurance Co.</td>
<td>$1,209.96</td>
</tr>
<tr>
<td>2. Mortgage Insurance Premium (12 mo.)</td>
<td></td>
</tr>
<tr>
<td>3. Prepaid Interest ($17.44 per day from 4/15/13 to 5/1/13)</td>
<td>$279.04</td>
</tr>
<tr>
<td>4. Property Taxes (6 mo.) to Any County USA</td>
<td>$631.80</td>
</tr>
<tr>
<td>5.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>G. Initial Escrow Payment at Closing</th>
<th>$412.25</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Homeowner’s Insurance $100.83 per month for 2 mo.</td>
<td>$201.66</td>
</tr>
<tr>
<td>2. Mortgage Insurance per month for 2 mo.</td>
<td></td>
</tr>
<tr>
<td>3. Property Taxes $105.30 per month for 2 mo.</td>
<td>$210.60</td>
</tr>
<tr>
<td>4.</td>
<td></td>
</tr>
<tr>
<td>5.</td>
<td></td>
</tr>
<tr>
<td>6.</td>
<td></td>
</tr>
<tr>
<td>7. Aggregate Adjustment</td>
<td>– 0.01</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>H. Other</th>
<th>$2,400.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. HOA Capital Contribution to HOA Acre Inc.</td>
<td>$500.00</td>
</tr>
<tr>
<td>2. HOA Processing Fee to HOA Acre Inc.</td>
<td>$150.00</td>
</tr>
<tr>
<td>3. Home Inspection Fee to Engineers Inc.</td>
<td>$750.00</td>
</tr>
<tr>
<td>4. Home Warranty Fee to XYZ Warranty Inc.</td>
<td></td>
</tr>
<tr>
<td>5. Real Estate Commission to Alpha Real Estate Broker</td>
<td>$5,700.00</td>
</tr>
<tr>
<td>6. Real Estate Commission to Omega Real Estate Broker</td>
<td>$5,700.00</td>
</tr>
<tr>
<td>7. Title – Owner’s Title Insurance (optional) to Epsilon Title Co.</td>
<td>$1,000.00</td>
</tr>
<tr>
<td>8.</td>
<td></td>
</tr>
</tbody>
</table>

| I. TOTAL OTHER COSTS (Borrower-Paid) | $5,018.05 |
| Other Costs Subtotals (E + F + G + H) | $5,018.05 |

| J. TOTAL CLOSING COSTS (Borrower-Paid) | $9,712.10 |
| Closing Costs Subtotals (D + I) | $9,682.30 | $29.80 |
| Lender Credits | $12,800.00 | $750.00 | $405.00 |

CLOSING DISCLOSURE
### Calculating Cash to Close

<table>
<thead>
<tr>
<th>Description</th>
<th>Loan Estimate</th>
<th>Final</th>
<th>Did this change?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Closing Costs (J)</td>
<td>$8,054.00</td>
<td>$9,712.10</td>
<td>YES - See Total Loan Costs (D) and Total Other Costs (I)</td>
</tr>
<tr>
<td>Closing Costs Paid Before Closing</td>
<td>$0</td>
<td>$29.80</td>
<td>YES - You paid these Closing Costs before closing</td>
</tr>
<tr>
<td>Closing Costs Financed (Paid from your Loan Amount)</td>
<td>$0</td>
<td>$0</td>
<td>NO</td>
</tr>
<tr>
<td>Down Payment/Funds from Borrower</td>
<td>$18,000.00</td>
<td>$18,000.00</td>
<td>NO</td>
</tr>
<tr>
<td>Deposit</td>
<td>$0</td>
<td>$0</td>
<td>NO</td>
</tr>
<tr>
<td>Funds for Borrower</td>
<td>$0</td>
<td>$0</td>
<td>NO</td>
</tr>
<tr>
<td>Seller Credits</td>
<td>$0</td>
<td>$2,500.00</td>
<td>YES - See Seller Credits in Section L</td>
</tr>
<tr>
<td>Adjustments and Other Credits</td>
<td>$0</td>
<td>$1,035.04</td>
<td>YES - See details in Sections K and L</td>
</tr>
<tr>
<td><strong>Cash to Close</strong></td>
<td><strong>$16,054.00</strong></td>
<td><strong>$14,147.26</strong></td>
<td></td>
</tr>
</tbody>
</table>

### SELLER’S TRANSACTION

<table>
<thead>
<tr>
<th>Description</th>
<th>Loan Estimate</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>M. Due to Seller at Closing</strong></td>
<td><strong>$180,080.00</strong></td>
<td></td>
</tr>
<tr>
<td>Sale Price of Property</td>
<td>$180,000.00</td>
<td></td>
</tr>
<tr>
<td>Sale Price of Any Personal Property Included in Sale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing Costs Paid at Closing (J)</td>
<td>$9,682.30</td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City/Town Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>County Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>Assessments</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>HOA Dues</td>
<td>4/15/13 to 4/30/13</td>
<td>$80.00</td>
</tr>
<tr>
<td><strong>N. Due from Seller at Closing</strong></td>
<td>$115,665.04</td>
<td></td>
</tr>
<tr>
<td>Excess Deposit</td>
<td>$10,000.00</td>
<td></td>
</tr>
<tr>
<td>Closing Costs Paid at Closing (J)</td>
<td>$12,800.00</td>
<td></td>
</tr>
<tr>
<td>Existing Loan(s) Assumed or Taken Subject to</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Payoff of First Mortgage Loan</td>
<td>$100,000.00</td>
<td></td>
</tr>
<tr>
<td>Payoff of Second Mortgage Loan</td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td>Seller Credit</td>
<td>$2,500.00</td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City/Town Taxes</td>
<td>1/1/13 to 4/14/13</td>
<td>$365.04</td>
</tr>
<tr>
<td>County Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>Assessments</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td><strong>CALCULATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Due from Seller at Closing (M)</td>
<td><strong>$180,080.00</strong></td>
<td></td>
</tr>
<tr>
<td>Total Due from Seller at Closing (N)</td>
<td>$115,665.04</td>
<td></td>
</tr>
<tr>
<td><strong>Cash From Seller to Seller</strong></td>
<td><strong>$64,414.96</strong></td>
<td></td>
</tr>
</tbody>
</table>

### BORROWER’S TRANSACTION

<table>
<thead>
<tr>
<th>Description</th>
<th>Loan Estimate</th>
<th>Final</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>K. Due from Borrower at Closing</strong></td>
<td><strong>$189,762.30</strong></td>
<td></td>
</tr>
<tr>
<td>Sale Price of Property</td>
<td>$180,000.00</td>
<td></td>
</tr>
<tr>
<td>Sale Price of Any Personal Property Included in Sale</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Closing Costs Paid at Closing (J)</td>
<td>$9,682.30</td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City/Town Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>County Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>Assessments</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>HOA Dues</td>
<td>4/15/13 to 4/30/13</td>
<td>$80.00</td>
</tr>
<tr>
<td><strong>L. Paid Already by or on Behalf of Borrower at Closing</strong></td>
<td><strong>$175,615.04</strong></td>
<td></td>
</tr>
<tr>
<td>Deposit</td>
<td>$10,000.00</td>
<td></td>
</tr>
<tr>
<td>Loan Amount</td>
<td>$162,000.00</td>
<td></td>
</tr>
<tr>
<td>Existing Loan(s) Assumed or Taken Subject to</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>City/Town Taxes</td>
<td>1/1/13 to 4/14/13</td>
<td>$365.04</td>
</tr>
<tr>
<td>County Taxes</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td>Assessments</td>
<td>to</td>
<td></td>
</tr>
<tr>
<td><strong>CALCULATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Due from Borrower at Closing (K)</td>
<td><strong>$189,762.30</strong></td>
<td></td>
</tr>
<tr>
<td>Total Paid Already by or on Behalf of Borrower at Closing (L)</td>
<td>$175,615.04</td>
<td></td>
</tr>
<tr>
<td><strong>Cash to Close</strong></td>
<td><strong>$14,147.26</strong></td>
<td></td>
</tr>
</tbody>
</table>
Additional Information About This Loan

Loan Disclosures

Assumption
If you sell or transfer this property to another person, your lender
☐ will allow, under certain conditions, this person to assume this loan on the original terms.
☒ will not allow assumption of this loan on the original terms.

Demand Feature
Your loan
☐ has a demand feature, which permits your lender to require early repayment of the loan. You should review your note for details.
☒ does not have a demand feature.

Late Payment
If your payment is more than 15 days late, your lender will charge a late fee of 5% of the monthly principal and interest payment.

Negative Amortization (Increase in Loan Amount)
Under your loan terms, you
☐ are scheduled to make monthly payments that do not pay all of the interest due that month. As a result, your loan amount will increase (negatively amortize), and your loan amount will likely become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.
☒ may have monthly payments that do not pay all of the interest due that month. If you do, your loan amount will increase (negatively amortize), and, as a result, your loan amount may become larger than your original loan amount. Increases in your loan amount lower the equity you have in this property.

Partial Payments
Your lender
☒ may accept payments that are less than the full amount due (partial payments) and apply them to your loan.
 ☐ may hold them in a separate account until you pay the rest of the payment, and then apply the full payment to your loan.
☐ does not accept any partial payments.

If this loan is sold, your new lender may have a different policy.

Security Interest
You are granting a security interest in
456 Somewhere Ave., Anytown, ST 12345

You may lose this property if you do not make your payments or satisfy other obligations for this loan.

Escrow Account
For now, your loan
☒ will have an escrow account (also called an “impound” or “trust” account) to pay the property costs listed below. Without an escrow account, you would pay them directly, possibly in one or two large payments a year. Your lender may be liable for penalties and interest for failing to make a payment.

<table>
<thead>
<tr>
<th>Escrow</th>
<th>Estimated total amount over year 1 for your escrowed property costs:</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2,473.56</td>
<td>Homeowner’s Insurance Property Taxes</td>
</tr>
<tr>
<td>$1,800.00</td>
<td>Non-Escrowed Property Costs over Year 1</td>
</tr>
<tr>
<td>$412.25</td>
<td>Initial Escrow Payment</td>
</tr>
<tr>
<td>$206.13</td>
<td>Monthly Escrow Payment</td>
</tr>
</tbody>
</table>

☒ will not have an escrow account because ☒ you declined it ☐ your lender does not offer one. You must directly pay your property costs, such as taxes and homeowner’s insurance. Contact your lender to ask if your loan can have an escrow account.

In the future,
Your property costs may change and, as a result, your escrow payment may change. You may be able to cancel your escrow account, but if you do, you must pay your property costs directly. If you fail to pay your property taxes, your state or local government may (1) impose fines and penalties or (2) place a tax lien on this property. If you fail to pay any of your property costs, your lender may (1) add the amounts to your loan balance, (2) add an escrow account to your loan, or (3) require you to pay for property insurance that the lender buys on your behalf, which likely would cost more and provide fewer benefits than what you could buy on your own.
Contact Information

<table>
<thead>
<tr>
<th>Lender</th>
<th>Mortgage Broker</th>
<th>Real Estate Broker (B)</th>
<th>Real Estate Broker ($)</th>
<th>Settlement Agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name</td>
<td>Ficus Bank</td>
<td>Omega Real Estate Broker Inc.</td>
<td>Alpha Real Estate Broker Co.</td>
<td>Epsilon Title Co.</td>
</tr>
<tr>
<td>Address</td>
<td>4321 Random Blvd. Somecity, ST 12340</td>
<td>789 Local Lane Sometown, ST 12345</td>
<td>987 Suburb Ct. Someplace, ST 12340</td>
<td>123 Commerce Pl. Somecity, ST 12344</td>
</tr>
<tr>
<td>NMLS ID</td>
<td>Z765416</td>
<td>Z61456</td>
<td>Z61616</td>
<td></td>
</tr>
<tr>
<td>ST License ID</td>
<td>Joe Smith</td>
<td>Samuel Green</td>
<td>Joseph Cain</td>
<td>Sarah Arnold</td>
</tr>
<tr>
<td>Contact</td>
<td>12345</td>
<td>P16415</td>
<td>P51461</td>
<td>PT1234</td>
</tr>
<tr>
<td>Contact NMLS ID</td>
<td>12345</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contact ST License ID</td>
<td>12345</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Email</td>
<td><a href="mailto:joesmith@ficusbank.com">joesmith@ficusbank.com</a></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phone</td>
<td>123-456-7890</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Questions? If you have questions about the loan terms or costs on this form, use the contact information below. To get more information or make a complaint, contact the Consumer Financial Protection Bureau at www.consumerfinance.gov/mortgage-closing

Loan Calculations

| Total of Payments. Total you will have paid after you make all payments of principal, interest, mortgage insurance, and loan costs, as scheduled. | $285,803.36 |
| Finance Charge. The dollar amount the loan will cost you. | $118,830.27 |
| Amount Financed. The loan amount available after paying your upfront finance charge. | $162,000.00 |
| Annual Percentage Rate (APR). Your costs over the loan term expressed as a rate. This is not your interest rate. | 4.174% |
| Total Interest Percentage (TIP). The total amount of interest that you will pay over the loan term as a percentage of your loan amount. | 69.46% |

Other Disclosures

Appraisal
If the property was appraised for your loan, your lender is required to give you a copy at no additional cost at least 3 days before closing. If you have not yet received it, please contact your lender at the information listed below.

Contract Details
See your note and security instrument for information about
• what happens if you fail to make your payments,
• what is a default on the loan,
• situations in which your lender can require early repayment of the loan, and
• the rules for making payments before they are due.

Liability after Foreclosure
If your lender forecloses on this property and the foreclosure does not cover the amount of unpaid balance on this loan,
☒ state law may protect you from liability for the unpaid balance. If you refinance or take on any additional debt on this property, you may lose this protection and have to pay any debt remaining even after foreclosure. You may want to consult a lawyer for more information.
☐ state law does not protect you from liability for the unpaid balance.

Refinance
Refinancing this loan will depend on your future financial situation, the property value, and market conditions. You may not be able to refinance this loan.

Tax Deductions
If you borrow more than this property is worth, the interest on the loan amount above this property’s fair market value is not deductible from your federal income taxes. You should consult a tax advisor for more information.

Confirm Receipt
By signing, you are only confirming that you have received this form. You do not have to accept this loan because you have signed or received this form.

Applicant Signature Date Co-Applicant Signature Date
Preparing the Closing Disclosure

Generally, the settlement officer and the lender will collaborate to gather the data and calculations necessary to prepare the Closing Disclosure. Either the settlement officer or the lender may prepare the final Closing Disclosure, but it is the lender who is ultimately responsible for ensuring that the Closing Disclosure is available for the borrower’s inspection at least three business days prior to loan consummation. The lender must also obtain proof that the borrower received the Closing Disclosure.

A Closing Disclosure must be prepared for both the buyer and for the seller, although it is permissible for the buyer’s Closing Disclosure to show only his information and the seller’s to show only his. When the purchase does not involve any financing, the Closing Disclosure is not required but may be used for the sake of convenience.

Closing Disclosure Page 1

The data on Page 1 of the Closing Disclosure provides details about the loan:

• **Transaction details**, such as the closing date, parties to the transaction, and loan information

• **Loan terms** as found on the Loan Estimate, updated as necessary

• **Projected payments** that provide a complete picture of the borrower’s total monthly obligations over the life of the loan

• **Closing costs**, reflecting a detailed break-down of costs and cash to close found on Page 2 of the Closing Disclosure

Closing Disclosure Page 2

Page 2 of the Closing Disclosure itemizes the closing costs paid by the borrower, the seller, or by others, for example, fees required by the lender to make the loan, such as origination charges and escrow payments, as well as other costs necessary to conclude the transaction, such as government taxes. The columns for Borrower-Paid items and Seller-Paid items are divided into two parts:

• **Items paid at closing.** These items figure into the total costs owed by the buyer and seller on the day of closing.

• **Items paid before closing.** These items are noted here for both buyer and seller. Items the buyer paid before closing reduce the buyer’s cash to close calculation on Page 3. Items paid before closing are not included in the summaries of transactions for either buyer or seller, however.

Page 2 is also where any commission due is itemized.

Closing Disclosure Page 3

The Calculating Cash to Close Section of Page 3 has columns to compare items from the Loan Estimate to the Final amount to arrive at Cash to Close, which is the amount the borrower must bring to closing.
In the Summaries of Transaction tables, the amounts associated with the real estate purchase transaction between the buyer and seller, together with closing costs, are itemized in order to disclose the amounts due from the borrower or due to the seller at closing as applicable. The borrower’s debits and credits are on the left side of the page; the seller’s debits and credits are on the right side of the page.

The Borrower’s Transaction debits and credits and the Seller’s Transaction debits and credits are reconciled, with the final calculations indicated at the bottom of the page.

Closing Disclosure Pages 4 and 5

Pages 4 and 5 are primarily of interest to the borrower, as they provide details about the loan itself. Characteristics of the loan are found on Page 4, for example, whether there are late fees, an acceleration or due on sale clause, the possibility for negative amortization, and whether the loan may be assumed. Page 5 includes four sections:

- **Loan Calculations.** Details about the payments made by the borrower, such as total number of payments, finance charge, and the annual percentage rate.

- **Other Disclosures.** Miscellaneous disclosures to the borrower about their ongoing rights and responsibilities.

- **Contact Information.** Includes lender, mortgage broker, real estate broker(s), and settlement agent as applicable.

- **Confirm Receipt.** The signature(s) of the borrower(s).

Revisiting the Loan Estimate

Long before receiving the Closing Disclosure prior to settlement, buyers should have a clear picture of the closing costs associated with the transaction. Recall that the Real Estate Settlement Procedures Act requires lenders to provide loan applicants with a good faith estimate of closing costs in a standardized Loan Estimate within three business days of applying for a loan. If either the Loan Estimate or the Closing Disclosure do not accurately reflect the actual closing and loan costs, the settlement process could be delayed until the lender presents updated disclosures.

An updated Closing Disclosure is required if:

- The APR (annual percentage rate) shown in the Loan Estimate increases by more than 1/8 of a percent for fixed-rate loans or 1/4 of a percent for adjustable loans.

- A prepayment penalty is added, making it expensive to refinance, sell, or pay off the loan early.

- The basic loan product indicated in the Loan Estimate changes, such as a switch from fixed rate to adjustable interest rate or to a loan with interest-only payments.

An updated disclosure would trigger another three business-day waiting period. The timing requirements for disclosure could result in delays with last-minute negotiations. Scheduling back-to-back closings when the sale of one property is contingent on the closing of another property, for example, can be risky.
Prorated Expenses

While debits and credits may be simple to assign for settlement, there are some expenses that may not be the responsibility of just the buyer or the seller. Proration is the division of expenses between buyer and seller in proportion to the actual usage of the item represented by a specific expense as of the day the loan is funded. A proration is also known as an adjustment.

To adjust a cost that is shared by both buyer and seller, it's necessary to determine whether the expense is accrued or prepaid.

Accrued Expenses

Accrued expenses are the items on a settlement statement for which the cost has been incurred, but the expense has not yet been paid. Accrued expenses may also be referred to as expenses that are paid in arrears. Examples of accrued expenses may include unpaid recurring assessments, ad valorem property taxes (in most states), and interest on new mortgage loans or assumed mortgages (principal is never prorated). Accrued items start from the position that nothing has been paid, so these expenses must be calculated so the seller can be debited and the buyer credited for this amount.

For Example

A transaction closes on May 31. The neighborhood has a special assessment for sidewalks that is due twice a year, paid in arrears. The next assessment payment is due June 30, so the buyer would have to pay that. Since the seller lived in the house for five of the six months covered by the unpaid assessment, the seller must pay her share of the bill. The assessment will be prorated on the settlement statement as a debit of five months’ expense to the seller and a credit of five months’ expense to the buyer.

Prepaid Expenses

Prepaid expenses are items that a buyer or seller have paid outside of closing (P.O.C.). When discussing prorations, prepaids are most often expenses that the seller has already paid but that the buyer will use. For example, homeowners insurance, association fees, utility bills, and special assessment taxes may be prepaid costs. Since the seller has already paid for these expenses outside of closing, the seller is entitled to a credit for the portion paid but that will not be used. The prepaid expense is then a debit to the buyer. When a buyer prepays expenses, on the other hand, it does not result in a debit to the seller.

For Example

A transaction closes on July 31. The homeowners association requires annual fees to be paid at the beginning of the year. The seller lived in the house for seven months of the year and is therefore responsible for that portion of the association fee. At settlement, the fee would be prorated so that the seller is credited for the remaining five months of the association fee that has already been paid. The buyer’s side will show a debit for five months of association fees.
**Day of Closing**

Generally speaking, buyers become the owners of the property they purchase on the closing date. In practice, however, the buyer or seller may be charged with that day’s fees and expenses. This is often based on local custom. The day of closing may, by agreement, be entirely allocated to the seller or to the buyer regardless of the time of day the closing takes place. The day of closing, therefore, “belongs to” either the seller or the buyer for purposes of prorating.

All prorations are calculated as of midnight. In this way, a day does not have to be divided into hours or minutes, which would make the calculations more complex.

**Methods of Proration**

When performing proration calculations, it’s important to know the factor on which to base the adjustment. Expenses may be prorated using:

- A 360-day year, 12 months of 30 days each (sometimes referred to as a “banker’s year” or a “statutory year”).
- A 365-day year, counting the exact number of days in each month (or 366 days during a leap year).

The decision about which calculation to use may be based on local custom or the type of expense. It’s important to find out which factor is used.

Either way, the steps to calculate the adjustment are similar:

**Step 1:** Determine if the expense is accrued or prepaid.

**Step 2:** Divide the expense by the appropriate period to find a monthly/daily rate.

**Step 3:** Determine how many months/days are affected by the expense.

**Step 4:** Multiply the monthly/daily rate by the number of affected months/days.

**Step 5:** Determine which party is credited and which is debited.

---

**For Example**

Property taxes of $2,140 are due June 30 and December 31; these are paid in arrears. The transaction closes on September 15. Using a statutory 360-day year with the day of closing belonging to the seller:

**Step 1:** Property taxes are paid in arrears (accrued); the buyer will be required to pay them at the end of the tax period

**Step 2:** $2,140 taxes ÷ 180 days (6 months) = $11.89 per day

**Step 3:** July (30 days) + August (30 days) + September 1 to September 15 (15 days) = 75 days

**Step 4:** 75 days x $11.89 per day = $891.75

**Step 5:** The buyer is credited $891.75; the seller is debited $891.75
### For Example

Condominium fees of $275.50 are paid on the first of every month to cover that month. The transaction closes on July 17. Using a 365-day year:

**Step 1:** Condo fees are a prepaid item that the seller paid

**Step 2:** $275.50 fee ÷ 31 days in July = $8.89 per day

**Step 3:** July 17 to July 31 = 15 days that the buyer lived in the house for the month of July

**Step 4:** 15 days x $8.89 = $133.35

**Step 5:** The seller is credited $133.35; buyer is debited $133.35

### Proration by Usage

Sometimes the cost of an item to be shared by seller and buyer is not prorated on a daily basis, but is prorated based on usage.

**For Example**

The seller pays $827 to fill a fuel oil tank on the property. On the day of closing, the tank is still 2/3 full. The seller has paid 100% of the cost, but the buyer will receive 66.67% of the benefit. This is a simple calculation:

\[ \text{\$827 x 0.667 = \$551.61} \]

On the Closing Disclosure, the seller is credited $551.61 and the buyer is debited $551.61.

### Mortgage Interest

An item that may show up on only the borrower’s side of the settlement statement is a mortgage interest proration. When a borrower closes a new mortgage loan at settlement, that first payment is not due until the first of the month after the next full month. For example, settlement is on April 17. The first mortgage payment is not due until June 1. The mortgage interest is paid in arrears, so that June payment covers the interest for May. The lender, however, will want to collect the interest for those days in April. A similar proration formula applies, once you find the daily interest rate:

**Step 1:** Determine the annual interest (loan amount x interest rate).

**Step 2:** Divide annual interest by 360 (using a statutory year, or 365 using a calendar year) to find the daily interest (usually to four decimal points).

**Step 3:** Multiply the daily interest by the number of affected days to find the interest proration to be debited from the borrower.

**For Example**

The buyer is taking out a $248,000 mortgage at 5 1/2% interest.

**Step 1:** The annual interest is $13,640 ($248,000 x 0.055).

**Step 2:** Divide $13,640 by 360 to find the daily interest: $37.8888.

**Step 3:** He’s closing on April 17, so there are 13 affected days: 13 x $37.8888 = $492.55.

The buyer must bring an additional $492.55 to closing to cover the mortgage interest for the last 13 days in April. This is why many buyers prefer to close on the last day of the month.
Challenge Activity

Using the given data, determine what the buyer owes and the seller will receive at closing (assume a 360-day year for prorations and that the seller owns the day of closing).

- A is buying B's house for $200,000. Settlement is July 21.
- A is getting an 85% LTV mortgage at 4% interest. She made a $10,000 earnest money deposit.
- A's settlement costs total $8,000.
- Annual ad valorem property tax, paid in arrears, is $3,420.
- B filled a fuel oil tank for $780 in January that is still 3/4 full at closing.
- B paid semi-annual homeowners association fees of $360 on July 1 to cover the rest of the year.
- B pays 6% commission to the participating brokers; other settlement costs total $3,200.
- B owes $95,000 on existing mortgage.

<table>
<thead>
<tr>
<th>A: Buyer's Summary</th>
<th>B: Seller's Summary</th>
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<tr>
<td><strong>Contract Sales Price</strong></td>
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<tr>
<td><strong>Buyer Paid at Closing</strong></td>
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<td><strong>Settlement Charges</strong></td>
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<td><strong>Mortgage Interest</strong></td>
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<td><strong>HOA Fees</strong></td>
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<td><strong>Gross Amount From Borrower</strong></td>
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<td><strong>Paid By/On Behalf of Borrower</strong></td>
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<td><strong>Gross Amount Due From Borrower</strong></td>
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<td><strong>Cash X To Borrower</strong></td>
<td><strong>Cash X To Seller</strong></td>
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<td><strong>HOA Fees</strong></td>
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<td><strong>Gross Amount Due Seller</strong></td>
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<td><strong>Reductions in Total Due Seller</strong></td>
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<td><strong>Settlement Charges</strong></td>
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<td><strong>Existing Mortgage Payoff</strong></td>
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<td><strong>Adjustments Unpaid by Seller</strong></td>
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<td><strong>Property Tax</strong></td>
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<td><strong>Total Reduction Due Seller</strong></td>
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<td><strong>Cash From/To Seller</strong></td>
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<td><strong>Gross Amount Due To Seller</strong></td>
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<td><strong>Less Reductions Due Seller</strong></td>
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<tr>
<td><strong>Cash From/To Seller</strong></td>
<td><strong>Cash X To Seller</strong></td>
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Summary

1. **Closing** is the transfer of real property ownership from a seller to a buyer, according to terms and conditions in a purchase agreement or escrow agreement. Closings can be **escrow closings** (conducted by a neutral third party—an escrow agent) or **roundtable closings** (with all parties present). Documents typically required for closing include: Evidence of title (usually title insurance), mortgage documents, the deed from the grantor, proof of insurance, inspections, surveys, tax forms, and a settlement statement.

2. The **Real Estate Settlement Procedures Act** (RESPA) regulates settlement and closing procedures and requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures. RESPA also prohibits kickbacks, limits escrow reserves, and requires disclosure of affiliated business arrangements. RESPA requires the use of a **Closing Disclosure** for federally related residential mortgages. It must be given to the buyer at least three business days prior to closing. The Closing Disclosure is prepared by the lender or settlement agent and itemizes all expenses and costs paid by the buyer and seller to close the real estate transaction.

3. Buyers and sellers incur costs necessary to close the real estate transaction. The payment of any item is usually negotiable between buyer and seller. **Sellers** can expect to pay: Attorney’s and broker’s fees, any existing liens on the property, recording fees, transfer taxes, and perhaps a fee for a home warranty. **Buyers** can expect to pay: Fees for appraisals, credit reports, and surveys; attorney’s fee; bank fees; recording fees; a mortgage recording tax; and title, mortgage. **Debits** (like debts) are any sum of money that is owed. A debit is charged to a party on a balance sheet to represent money that must be paid to the other party. **Credits** are indicated as that sum of money either already paid before closing, paid by a third party, or to be reimbursed at closing, whether it is the buyer or the seller. The mortgage is a credit to the buyer.

4. **Proration** is the adjustment of expenses between buyer and seller in proportion to the actual use of the item represented by a particular expense. **Accrued expenses** are the items on a settlement statement for which the cost has been incurred, but the expense has not yet been paid, for example, ad valorem property tax and mortgage interest. **Prepaid expenses** are the items on the settlement statement that the seller has already paid, but will not be used because he or she no longer owns the property, such as homeowners association fees or fuel oil. Prorations are calculated based on a 360-day year (12 months of 30 days each) or a 365-day year to account for the specific number of days in the proration period.
Chapter Quiz

1. RESPA applies to ___________________________ financed by a federally regulated loan.
   A. any commercial or residential property  
   B. any residential property  
   C. one- to four-family residences  
   D. single-family dwellings only

2. Which document is the most critical to settlement, basically laying the foundation for the closing?
   A. abstract of title  
   B. bill of sale  
   C. mortgage  
   D. purchase agreement

3. Buyer A and Buyer B are purchasing Seller C’s house. At closing, who signs the deed?
   A. Buyers A and B  
   B. Seller C  
   C. Buyers A and B, as well as Seller C  
   D. Seller C and the settlement officer

4. Which document at the closing table transfers title of personal property from one person to the other?
   A. bill of sale  
   B. deed  
   C. settlement statement  
   D. title report

5. What type of closing is conducted with all parties present?
   A. abstract  
   B. escrow  
   C. roundtable  
   D. settlement

6. The lender must provide the Closing Disclosure to borrowers at least _______ prior to closing.
   A. 1 business day  
   B. 3 business days  
   C. 3 calendar days  
   D. 5 business days

7. Seller T refuses to sign a purchase agreement unless buyer B agrees to use T’s Title Company. B really wants that house and so agrees. The fee for the title insurance is $400. If B later chooses to sue T for violating RESPA, what is the maximum amount she can get?
   A. B cannot sue under RESPA since she agreed to the terms.  
   B. B can only sue for the amount she paid: $400.  
   C. B can sue for up to two times what she paid: $800.  
   D. B can sue for up to three times what she paid: $1,200.

8. Which is LEAST LIKELY to be an example of an illegal kickback under RESPA?
   A. ABC Brokerage allows XYZ Title to use its downtown offices to conduct closings as a convenience to downtown clients.  
   B. Every month, B&B Title Company pays for a one-page ad in the local newspaper for the real estate brokerage that sends them the most referrals.  
   C. Home inspector H promises broker K tickets to a football game if he will send some business his way this year.  
   D. M&M Mortgage puts a link to R&R Realty’s website on its website in exchange for R&R sending buyer clients their way.

9. Real estate broker J also owns a mortgage company. Which of the following is TRUE under RESPA?
   A. J must advise his buyer to select a different mortgage company.  
   B. J may refer the buyer to his mortgage company if he discloses his interest in the company to the buyer.  
   C. J may not refer the buyer to his mortgage company, but if the buyer chooses the company independently, this is permitted, as long as J discloses his interest in the company.  
   D. J may not refer the buyer to his mortgage company, but if the buyer chooses the company independently, J has no obligation to disclose his interest in the company.
10. An updated Closing Disclosure is required if the annual percentage rate shown in the Loan Estimate increases by more than _____ for a fixed rate loan.
   A. 1/8 of a percent  
   B. 1/4 of a percent  
   C. 3/8 of a percent  
   D. 1/2 of a percent

11. Each of these costs is typically paid by the buyer EXCEPT
   A. discount points.  
   B. escrow reserves.  
   C. existing lien payoff.  
   D. mortgage insurance premiums.

12. What is an expense on a settlement statement for which the cost has been incurred but the expense has not been paid?
   A. accrued item  
   B. good faith estimate  
   C. prepaid item  
   D. proration

13. On the settlement statement, the sales commission is generally shown as a
   A. credit to the buyer.  
   B. credit to the seller.  
   C. debit to the buyer.  
   D. debit to the seller.

14. On the settlement statement, a new mortgage loan is generally shown as a
   A. credit to the buyer.  
   B. credit to the seller.  
   C. debit to the buyer.  
   D. debit to the seller.

15. Settlement for the sale of a condominium is March 31. The seller pays condo fees on the first day of every month. How will this fee appear on the settlement statement?
   A. a three-month credit to the buyer  
   B. a three-month debit to the buyer  
   C. a nine-month debit the buyer  
   D. It will not appear on the settlement statement.

16. A house sells for $185,900. In that state, the transfer tax is 55 cents for every $1,000 or fraction thereof. What is the transfer tax on this transaction?
   A. $33.80  
   B. $102.25  
   C. $102.30  
   D. $338.00

17. The sale of a property will close on April 30. Ad valorem property taxes are $3,390 per year and are paid in arrears. Calculate the tax proration using a calendar year (365 days).
   A. $1,114.51 Debit Seller / $2,275.49 Credit Buyer  
   B. $1,114.51 Debit Seller / $1,114.51 Credit Buyer  
   C. $2,275.49 Credit Seller / $1,114.51 Credit Buyer  
   D. $2,275.49 Debit Seller / $2,275.49 Credit Buyer

18. The sale of a property in a subdivision closes on August 31. The seller paid the annual association fee of $780 at the beginning of the year. On the settlement statement, how will this fee be handled (assuming a statutory year)?
   A. $259.99 Credit Buyer / $519.98 Debit Seller  
   B. $259.99 Credit Seller / $259.99 Debit Buyer  
   C. $519.98 Credit Seller / $519.98 Debit Buyer  
   D. $259.99 Debit Seller / $259.98 Credit Buyer

19. The sale of a house closes on September 30. The seller had filled the fuel oil tank in January at a cost of $820. When the transaction closes, the tank is 1/4 full. Determine how to prorate this item on the settlement statement.
   A. $615 Debit Seller / $615 Credit Buyer  
   B. $615 Debit Seller / $205 Credit Buyer  
   C. $205 Credit Seller / $615 Debit Buyer  
   D. $205 Credit Seller / $205 Debit Buyer

20. A buyer takes out a $315,000 loan at 5% interest. Settlement is April 16. How will the mortgage interest proration show up on the settlement statement (assume a statutory year)?
   A. $604.11 Debit Buyer  
   B. $604.11 Debit Buyer / $604.11 Credit Seller  
   C. $612.50 Debit Buyer  
   D. $612.50 Debit Buyer / $612.50 Credit Seller
Taxation and Investment

Taxes go hand in hand with land ownership. Anyone who owns land can expect to have their property assessed and then pay taxes on the assessed value. In this lesson, we’ll discuss the purpose of real estate taxes and see how to calculate property taxes. Income taxes may also come into play, for example when property is bought or sold, so we’ll also look at income tax deductions that may be available to property owners. These issues will be examined both from the perspective of a homeowner and an investor.

After reading this chapter, you will be able to:

• Recognize the taxation implications of homeownership and calculate property tax.
• Determine a property owner’s equity.
• Recall factors that influence investment decisions.
• Use various formulas to evaluate the performance of investment property.

Key Terms

1031 Exchange  Depreciation  Return on Investment (ROI)
Ad Valorem  Equity  Proforma Statement
Appreciation  Home Acquisition Debt  Risk
Assessed Value  Home Equity Debt  Special Assessment
Boot  Leverage  Straight-Line Depreciation
Capital Gain  Liquidity  Tax Depreciation
Cash Flow  Market Value  Tax Shelter
Cash-on-Cash Return  Millage
Debt Service  Return of Investment
Income Tax Considerations

There are a number of income tax considerations associated with the ownership of a residence.

Tax Deductions

The federal government recognizes the benefits of homeownership to society. To encourage people to purchase homes, the government has enacted numerous provisions into the tax code that can reduce the amount of income tax owed. The following are itemized deductions that may apply to one’s principal residence:

- **Interest** paid on a mortgage or deed of trust **up to $1 million** (home acquisition debt)
- Any **ad valorem property taxes**
- **Interest** paid on home equity loans, up to **$100,000** (providing the debt is not greater than the home’s fair market value)
- **Prepayment penalties** a lender assesses for paying off a mortgage before it is due
- **Losses** due to casualty not covered by insurance, including theft, fire, and flood
- **Use of property for an in-home office**

Owners of a **second home** can deduct only **property taxes** and **mortgage interest**. They can also exclude rental income if they do not rent the home for **more than 14 days** during the year.

Never give tax advice to anyone! Tax laws are complicated and change often, so licensees should encourage clients and customers to consult with tax professionals.

Expenses That Cannot Be Deducted

**Home repairs** that are made to simply **maintain** the property, such as painting, roof repairs, patching walls, and replacing wallpaper, are **not** deductible expenses. **Home improvements** are not deductible either, even those that add to the value of the home, extend its useful life, or convert it to a new use. So, a homeowner cannot deduct the cost of a patio or deck addition or a basement remodel, for example. An exception may be if the owner uses the home entirely for business or as rental property.

Homeowners **cannot deduct depreciation** of their principal residence from their income taxes.

Tapping Retirement Funds

In addition to the tax deductions, buyers may be able to access funds from their Independent Retirement Accounts (IRAs) to help purchase a **first home** with minimal tax consequences. The Internal Revenue Code allows buyers to apply up to **$10,000** toward the purchase without having to pay early withdrawal penalties. Those with a traditional IRA would still be required to pay income tax on the withdrawal. Funds from a Roth IRA that is at least five years old may be withdrawn tax-free.

Funds can also be withdrawn from a **401(k) retirement account**, although it is considered to be a “loan.” Account-holders must pay interest on the amount withdrawn and must repay the balance within a specified time period.
Sale of a Principal Residence

Taxes come into play during the sale of a principal residence. Capital gains are the profit made from an investment, which is taxed at a special capital gains tax rate. It's not unusual for a homeowner to sell his house for tens of thousands of dollars more than he originally paid for it. The capital gains tax on that much profit could be very expensive.

The federal Taxpayer Relief Act of 1997 created a provision to protect property owners by adding Section 121 to the Internal Revenue Code. Section 121 allows homeowners to exclude most or all the capital gains from being taxed when they sell their principal residence.

A capital loss occurs when an investment decreases in value. Losses on the sale of a personal residence are not deductible.

Section 121 Conditions

Homeowners must meet specific conditions to use the Section 121 exemption. For example, the taxpayer must have owned and used the property as a principal residence for at least two of the last five years prior to the date of sale. It does not have to be the principal residence on the date of sale.

Generally, the provisions of Section 121 of the Taxpayer Relief Act of 1997 can be invoked only once every two years. There are special circumstances provided in the code that will exempt some homeowners from capital gains tax, even if it has been less than 24 months since the homeowner last invoked the exemption:

CHANGE IN EMPLOYMENT Under Section 121, a change in employment may allow taxpayers to deduct their moving expenses from the capital gains, but there is a specific requirement: The location of the new place of employment must be at least 50 miles farther from the old residence than that residence was from the former job.

HEALTH CONSIDERATIONS For health exceptions to apply, the sale of the home must be to obtain a change in residence to provide for the diagnosis, cure, or treatment of a disease, illness, or injury, or to obtain or provide medical or personal care from someone suffering from a disease, illness, or injury. Some examples include:

- Moving because a person is unable to care for herself
- Moving to a climate that will minimize the effects of a disease
- Moving closer to a recognized treatment facility

UNFORESEEN CIRCUMSTANCES Occasionally, circumstances arise that are beyond the taxpayer's control. The last set of provisions makes exceptions for other conditions. The most common include:

- Cessation of employment
- Death
- Disaster
- Divorce
- Involuntary conversion (eminent domain)
- Multiple births

These exemptions on capital gains tax do not apply to income-producing property.
Exclusion Limits

There are limits on the total allowable capital gains exclusions under Section 121 of the Taxpayer Relief Act of 1997:

- **$250,000** for a single person
- **$500,000** for a married couple filing joint returns

There are some additional requirements to be eligible for the $500,000 exclusion:

- One or both spouses must have owned and used the property as their principal residence for two of the last five years.
- Neither spouse could have sold another principal residence within the last two years.

If a surviving spouse sells the home in the same year during which their spouse dies, the $500,000 exemption is allowed for the surviving spouse.

Applying the Exclusion

The exclusion is applied to the **realized gain**, not the sale price. To calculate the realized gain:

1. Subtract the original cost of the property from the amount realized (which is the sales price less selling expenses) to find the **realized gain**.
2. Subtract the Section 121 exclusion from the realized gain. This is the **recognized gain**, which is the amount that will be taxed at the capital gains rate.

The exclusion amount may seem extraordinarily large. However, lawmakers considered **appreciation**, which is the increase in value of the asset over time, when they drafted the law. This prevents most people from an enormous tax burden simply because they have lived in a home for many years.

Property Tax

Of course, it's not just income taxes that impact homeowners. The government levies property taxes against their property as well. Property taxes can take two forms:

- **Ad valorem**, a Latin phrase meaning “according to value,” refers to the property taxes that are based on the assessed value of the property.
- **Special assessments** are taxes that pay for public improvements such as new sewers, streetlights, or curbs in a neighborhood. Only the property owners who benefit from an improvement are required to pay their share of its cost.

Benefits of Taxation

A question many property owners have is, “Why tax my land?” Even though there are drawbacks to taxing land, the benefits of doing so often outweigh the perceived problems. Here are some reasons why local governments choose to impose real property taxes rather than raise revenue solely through sales and/or income tax:

- Property taxes are relatively easy to administer because they are imposed on a known, stable tax base.
• Property taxes are predictable. Municipalities can count on a steady stream of income from the time a property is assessed until it is reassessed.

• Property taxes are somewhat protected in slow economies when compared to other types of taxes.

• Property taxes do not distinguish between resident and non-resident home and business owners—all land is taxed whether it is owned by a resident or not, so no one is “missed” in the process.

• Property taxes are the one single identifiable local revenue source for municipalities and schools, which makes local government directly accountable for executing operations and programs in a cost-effective manner.

The money earned through taxes covers the expenses of services that benefit the residents, for example:

• Municipal services such as sewers and streetlights
• City parks and playgrounds
• Public school funding
• Road and sidewalk maintenance
• Police and fire protection

All real property may be subject to property taxes. That includes the land itself and any improvements on it, including houses, factories, barns, stores, apartments, hotels, restaurants, office buildings, and on and on. It does not matter if it’s a small cabin or a large industrial park; nearly every property owner is responsible for paying taxes on his property.

**Exempt Properties**

Most taxing jurisdictions do recognize certain properties that are given either complete or partial exemption from paying property taxes. For example:

• Government entities, at all levels—federal, state, and local
• Religious organizations
• Schools, including colleges and universities
• Parks
• Hospitals
• Airports
• Embassies or consulates
• Historic areas or buildings
• Native American reservations

To obtain tax exemptions, however, the owner generally must use the property for tax-exempt purposes. If it is not being used in this capacity, the land is likely subject to tax.

Some taxing jurisdictions also allow a partial exemption of property tax liability to persons who are disabled or elderly, to farmers, or to veterans.
**Assessment**

A *tax assessor* is a local government official who has either been elected or appointed to estimate the value of real property within the boundaries of a specific municipal entity that has the authority to tax real property. Like an appraiser, a tax assessor estimates the *market value* of property, which is *the theoretical price that a piece of property would bring if sold on the open market for a reasonable period of time*. Of course, in this instance, the valuation is not done for the purpose of selling the property, but so that the assessor can ensure that each owner in her jurisdiction pays a fair share of the taxes.

Remember that *market value* is NOT the same thing as *market price*, which is the amount the property actually sold for.

**Assessed Value**

Once an assessor arrives at a determination of market value for a property, that value is converted to the *assessed value*, or assessment. In some taxing jurisdictions, a property’s assessed value is the same as the assessor’s estimate of its market value. In other words, if the assessor determines that the market value of the property was $240,000, the property’s assessed value is also $240,000.

Other jurisdictions base the level of assessment on a *percentage of the market value*. This may be referred to as a *tax ratio*. For example, if the tax ratio in a town is 50%, and the assessor determines the market value of a property to be $240,000, that property’s assessed value would be $120,000. If the market value of a neighboring property is determined to be $300,000, its assessed value would be $150,000.

Most taxing jurisdictions give property owners a statutory period of time during which to challenge an assessment. It’s important to note, however, that a tax assessor does not determine the property tax. A property’s *assessed value* is just one component in the calculation of real property taxes.

**Tax Rates**

*Tax rates* are a direct result of the tax *levy*. Each taxing jurisdiction—for example, a county, town, school district, etc.—analyzes all sources of revenue to determine how much property tax revenue is needed to meet the budget. The taxing jurisdiction then considers the total assessed value of the real property to determine the tax rate, which can be expressed in any of four ways, depending on local customs (all are equivalent):

- Dollars and cents *per $100* of assessment
- Dollars and cents *per $1,000* of assessment
- *Millage*, where 1 mill = $1 per $1,000 of assessment
- *Percent*
Calculating Taxes

To calculate the annual property taxes, simply multiply the assessed value by the appropriate tax rate, accounting for the way the tax rate is expressed. For example, the assessed value of a property is $150,000 and the county tax rate is 14 mills. To find the annual taxes:

<table>
<thead>
<tr>
<th>Tax Rate</th>
<th>Steps</th>
<th>Example</th>
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<tbody>
<tr>
<td>“$1 per $100”</td>
<td>1. Take the assessed value; divide by 100 to find the number of $100-taxing units. 2. Multiply that amount by the appropriate tax rate.</td>
<td>1. $150,000 ÷ $100 = 1,500 2. 1,500 x $1.40 = $2,100</td>
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<tr>
<td>or $1.40 per $100</td>
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<tr>
<td>“$1 per $1,000”</td>
<td>1. Take the assessed value; divide by 1,000 to find the number of $1,000-taxing units. 2. Multiply that amount by the appropriate tax rate.</td>
<td>1. $150,000 ÷ $1,000 = 150 2. 150 x $14 = $2,100</td>
</tr>
<tr>
<td>or $14 per $1,000</td>
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<tr>
<td>“Millage”</td>
<td>1. Take the millage; move the decimal point three places left. 2. Multiply that amount by the assessed value.</td>
<td>1. 14 mills = .014 2. .014 x $150,000 = $2,100</td>
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<tr>
<td>or 14 mills</td>
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<td></td>
</tr>
<tr>
<td>“Percent”</td>
<td>1. Take the percent; move the decimal point two places left. 2. Multiply that amount by the assessed value.</td>
<td>1. 1.4% = .014 2. .014 x $150,000 = $2,100</td>
</tr>
<tr>
<td>or 1.4%</td>
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Depending on the information provided in a problem, Circle-Math can help solve any variation of the tax formula. When you know two factors, you can find the third.

- Assessed Value x Tax Rate = Annual Taxes
- Annual Taxes ÷ Assessed Value = Tax Rate
- Annual Taxes ÷ Tax Rate = Assessed Value

Tax Liens

Real property taxes create an involuntary, specific lien against real property to secure the payment of real estate taxes that are owed and unpaid. Recall that a lien is defined as a financial encumbrance or nonpossessory interest in the real property.

When property owners default on tax payments, the lienholder can commence a tax foreclosure proceeding. Property tax liens always have a higher priority over other previously recorded liens from the proceeds of a foreclosure sale. It is for this reason that many lenders prefer to maintain an escrow account to ensure that property taxes will be paid, thus keeping themselves in first lien position.
Challenge Activity

Practice using the Circle-Math formula for calculating assessed value, tax rates, and property taxes owed.

1. This year, the school system collects 12 mills in property tax. Calculate the annual school tax for a property assessed at $318,750.

2. What must a property's assessed value be if its taxes are $1,800 and the property is taxed at 72 mills?

3. What tax rate was used for a property assessed at $148,900 that generates $8,200 in annual taxes?

4. A property with the appraised value of $580,000 is assessed at 40%. The annual taxes are $6,496. What is the tax rate?

5. A property is appraised at $175,000 and assessed for tax purposes at 50% of value. What are the semi-annual taxes if the tax rate is $65 per $1,000?

6. Property taxes on a parcel of land are $2,120. The property was assessed at 35% of market value and the tax rate is 47 mills. What is the market value of the real estate? (round to the nearest dollar)
**Equity**

Although most homeowners consider their principal residence as simply a place to live, many people also recognize their home as an investment that can increase in value over time. **Equity** is the difference between the value of a home and the total amount of any liens—such as a mortgage—against it. When purchasing a new home, the down payment is usually the only equity the property owner has. For example, B buys a home for $250,000. She gets a $225,000 loan and puts $25,000 down. Her equity in the property is $25,000.

**Increasing Equity Through Repayment**

Over time, with every payment a borrower makes on a mortgage loan, the equity in the property increases as the loan balance decreases. Use this equation to find the equity:

\[
\text{Property Value} - \text{Current Balance of Liens} = \text{Equity}
\]

**For Example**

In 10 years, B has paid her loan balance down to $147,000. Her equity in the property is now $103,000:

\[
\$250,000 \text{ (Property Value)} - \$147,000 \text{ (Current Loan Balance)} = \$103,000 \text{ (Equity)}
\]

The longer B lives in that house and pays down the mortgage, the more her equity in the property increases.

**Increasing Equity Through Appreciation**

Equity also increases as the property **appreciates**, which is an increase in value over time. Appreciation can occur for a variety of reasons, such as:

- The demand for property increases in the area because of economic growth, market trends, etc.
- The property owner improves the property, assuming the cost of the improvements contribute to its overall value.

**For Example**

Property values have increased in B’s neighborhood in the past 10 years. An appraiser now values her home at $280,000, which is $30,000 more than she paid for it. That $30,000 of appreciation, or change in value, is also equity that B now has in the home.

\[
\$280,000 \text{ (Property Value)} - \$147,000 \text{ (Current Loan Balance)} = \$133,000 \text{ (Equity)}
\]
Calculating Profit and Loss

Finding the basic percent of profit or loss on the sale of real property is a simple calculation when you know the original purchase price and the eventual sale price. First, determine the amount made or the amount lost on the sale. For example, B purchased a house for $250,000. Ten years later, she sold it for $285,000, making a profit of $35,000 ($285,000 - $250,000). The formula to calculate profit can be remembered as:

\[
\frac{\text{What You Made}}{\text{What You Paid}} = \text{Percent of Profit}
\]

\[
\frac{\$35,000}{\$250,000} = 0.14 \text{ or } 14\% \text{ (Profit)}
\]

B made 14% on the sale of the property. This is also known as return on investment, or ROI.

What if, instead, she sold that same property for $242,000? First, determine the amount she lost: $250,000 - $242,000 = $8,000. The formula to calculate loss can be remembered as:

\[
\frac{\text{What You Lost}}{\text{What It Cost}} = \text{Percent of Loss}
\]

\[
\frac{\$8,000}{\$250,000} = 0.032 \text{ or } 3.2\% \text{ (Loss)}
\]

Investment Fundamentals

There is no shortage of investment opportunities in the marketplace. Examples include savings accounts, certificates of deposits, money market accounts, oil and gas, stocks and bonds, Treasury bills, commodities futures, fine art and other collectibles, precious metals, and real estate. No matter what the commodity, investors select the investments they believe most closely meet their goals.

Investment Goals

A primary goal of any investor is the preservation of the capital invested, in other words, the return of his investment. One main attraction of investing in real estate, however, is its capability of producing or earning an acceptable return on the capital used to acquire it.

When a purchaser invests in real estate, he is trading a lump sum of capital in the present for the expectation of one or more of the following:

- Receiving a continuing stream of income from rent (cash flow)
- Earning a return on his investment when the property is sold
- Building equity in the investment through leverage, amortization, and appreciation
- Creating a tax shelter, which gives owners certain income tax advantages, such as deductions for property taxes, mortgage interest, and depreciation

Depending on the rate of return, the total investment is often not realized until the real estate is sold. Therefore, it is necessary to analyze the investment for the entire ownership period. First, it’s helpful to understand some basic investment concepts, including risk, liquidity, and leverage.
Risk

Risk is the possibility of losing either the principal invested and/or the potential income from the investment. For example, vacancy rates in an office building may be higher than anticipated, or market rental rates at the time of lease renewals may be lower than predicted. Because actual events in the market can differ from what investors contemplate at the time the property is purchased, the investor’s actual rate of return can differ from the return for which they hoped. Thus, we can view risk as the degree of probability the actual rate of return earned will differ from the return expected when the investment was made.

Because investors have many outlets for investing their money, real estate must compete with alternative investments for funds and the expected returns from real estate must be comparable to returns from other investments with similar risks. An investor’s tolerance for risk will have a great impact on their willingness to invest in real estate, because an acceptable level of risk means different things to different investors.

Market Risk

There are several types of risk that affect real estate. A critical consideration is market risk, which is the risk that demand for space will affect rents, vacancy rates, and net operating income (NOI). This is essentially the impact of supply and demand. For example, if a developer opens a new high-rise building with hundreds of office suites available, it could create a glut in the market, thus lowering demand for space. Conversely, if space is limited, demand is high. Market risk is also affected by the location of the property and the type of property (office, retail, industrial, etc.).

Capital market risk is the risk that changes in the financial markets will affect the value of real estate. Note that this differs from changes in the supply of and demand for space. Capital market risk is affected by changes in the level of interest rates, changes in the availability of mortgage and equity capital, and changes in the rate of return for alternative investment opportunities.

Other Types of Risk

- Environmental risk is the risk that the value of a property will be influenced by environmental factors that affect the owner’s ability to develop or lease the space. Examples include properties that contain asbestos, lead-based paint, and black mold. Environmental risk is often difficult to measure, and sometimes the cost to fix the problems can exceed the value of the property itself.

- Technology risk exists due to the fact that ever-changing technology creates obsolescence among businesses.

- Management risk exists because property management can affect the performance of a property. There is the cost and complexity of monitoring an investment and some properties require more specialized management than others.

- Legislative risk is the risk that changes in laws and regulations—such as zoning ordinances and tax laws—will affect the market value of the property.
Liquidity

**Liquidity** is the ability to convert an asset into cash quickly without the loss of principal. **Marketability**, on the other hand, is the ability to convert an asset to cash quickly, at any price.

The full value of a real estate investment property is usually not immediately convertible to cash without some loss of total value. This characteristic of real estate makes it one of the more non-liquid or illiquid of the various investment alternatives. From an investment perspective, then, the illiquidity of real property is a disadvantage.

Leverage

**Leverage** is the investment tactic of using borrowed funds, such as a mortgage, to increase the potential return on an investment. The use of leverage, also called the use of “other people’s money” (OPM), allows investors to compound their own buying power, thus enabling them to buy a much larger property, or perhaps more property, than they otherwise could if an entire purchase had to be made using only their own funds.

**For Example**

Here’s a simple illustration: An investor has $60,000 to invest. Without financing, she could buy one $60,000 property. If she sells the property for $63,000, she has made $3,000 on her investment, giving her a return of 5%:

\[
\frac{3,000}{60,000} = 0.05 \text{ or } 5\% \text{ (Profit)}
\]

What if, instead, she puts $10,000 down on six different $60,000 properties and finances the purchases? If she sells the six properties for $63,000 each, she has made $18,000 on her investment ($3,000 x 6 properties), giving her a return of 30%:

\[
\frac{18,000}{60,000} = 0.30 \text{ or } 30\% \text{ (Profit)}
\]

That is the beauty of using other people’s money.

**For Example**

Here’s another simple example. An investor buys a rental property for $150,000. He puts $40,000 down and finances the remaining $110,000 at 6%. A year later, he recognizes $12,000 in net income. After subtracting the debt service he paid on the loan ($8,040), his profit (cash flow) is $3,960, for a 9.9% return on his investment:

\[
\frac{3,960}{40,000} = 0.099 \text{ or } 9.9\% \text{ (Profit)}
\]

If he had not financed the purchase of the property, his return is only 8%:

\[
\frac{12,000}{150,000} = 0.08 \text{ or } 8\% \text{ (Profit)}
\]

Tax Advantages

A **tax shelter** is an investment that gives owners certain income tax advantages when deductions—such as expenses, property taxes, mortgage interest, and depreciation—exceed the cash flow. There are several ways in which a property owner can “shelter” other income from taxes.
Depreciation

Generally speaking, depreciation can be thought of as the loss of value to a property over the time during which it is expected to be useful. The Internal Revenue Service recognizes the reality that a real estate investment property does wear out over time and, therefore, allows an accounting deduction that reflects this economic fact in the form of cost recovery.

When accounting taxes on investment property, depreciation is not a true reflection of the property’s actual value, and it is not an out-of-pocket expense. Instead, the annual statutory amount of depreciation for investment property is the result of an apportioned allowance spread over the designated useful life of a building.

Remember: The depreciation deduction applies only to investment property. A primary residence can NEVER be depreciated for tax purposes.

Statutory Recovery Period

The simplest method of calculating depreciation is called straight-line depreciation. With this, the loss in value is figured equally over the recovery period. Federal income tax laws set the recovery periods as follows:

- Residential investment property: 27 1/2 years
- Commercial investment property: 39 years

If an investor purchased an apartment building today, the building will have fulfilled its useful life in 27 1/2 years, according to the IRS. Obviously, a well-maintained building will likely increase in value in that time period, but allowing a deduction for depreciation is an incentive for investors to purchase real property.

Remember: Only buildings (improvements) can depreciate, NOT the land on which the building sits.

Calculating Depreciation

Because land does not depreciate, the property owner must first deduct the value of the land from the total property value to find the value of the improvements. Then, to calculate depreciation, divide the value of the improvements by the recovery period.

\[
\text{Improvement Value ÷ Recovery Period = Annual Amount of Depreciation}
\]

For Example

A four-unit apartment building is valued at $650,000. The land on which it sits is valued at $240,000. The value of the improvements, therefore, is $410,000. Divide the improvement value by the recovery period for residential investment property (27 1/2 years) to find the annual depreciation:

\[
\$410,000 ÷ 27.5 = \$14,909.09 \text{ (Annual Depreciation)}
\]

The property owner could deduct $14,909.09 from his income tax as depreciation on his rental property.
1031 Exchanges

The Internal Revenue Code Section 1031 allows a taxpayer to sell an investment property and purchase another investment property in its place without paying capital gains taxes on the proceeds at the time of the sale. In essence, the taxpayer has more buying power in the second purchase because he can use the funds that otherwise would have been paid in taxes for part of his purchase. These types of transactions are called 1031 exchanges, like-kind exchanges, or tax-deferred exchanges.

For example, under the 1031 exchange, an investor might sell a four-family apartment building and purchase a small office building or vacant land held for development. Then some, or all, of the capital gains that normally would have been generated and taxed from the sale of the first property are deferred until the newly purchased property is sold.

This does not eliminate the tax but allows it to be recognized in a later tax year. This can be an advantage in tax planning, particularly if an investor expects to be in a lower income tax bracket in future years.

As of this printing, the federal government has been contemplating the elimination of Section 1031 exchanges as part of a broad tax overhaul. To reiterate: Do not give tax advice, but encourage clients to consult with tax professionals.

Required Conditions

Such exchanges of property are not taxed provided certain conditions are met:

- The transaction must be an exchange and not a sale (i.e., actual property must be exchanged, not solely property for cash).
- Transactions are structured as tax-deferred exchanges or exchanges where the taxable gain is deferred until a later date.
- Property received and property transferred must be held either for use in a trade or business or for investment.
- Properties must be similar or like-kind.

Property Exceptions

Generally, any real property used for business or investment can be exchanged for any other real property, regardless of improvements. Similarly, personal property (personalty or chattel) can be exchanged for any other personal property. However, the following transactions cannot be treated as like-kind exchanges:

- Livestock of different sexes
- Personal property for real property (and vice versa)
- Real property in the United States for real property in a foreign country
- Inventory, stocks, bonds, or other securities
Timing of a 1031 Exchange

The exchange of property can be either delayed or non-simultaneous. However, there are time limits within which the exchange must be completed:

- The new property must be identified within 45 days of the date of the sale of the old property.
- The new property must be received by the earlier of 180 days of the date when the old property was sold or the due date for the tax return covering the tax year of the transfer.

Boot

Occasionally, property that is not like-kind can be a part of a like-kind exchange to make up for a pricing disparity between the like-kind properties. This extra, non-like-kind, property is called boot. To determine whether a gain must be realized, the entire transaction must be analyzed to determine if any gain has occurred. Receiving boot will generally trigger a recognized gain in the amount of the lesser of the fair market value of the boot received or the realized gain.

Qualified Intermediaries

When transacting a Section 1031 exchange, a qualified intermediary will safeguard the assets of each party throughout the exchange process, especially in the case of delayed exchanges. A qualified intermediary is responsible for:

- Preparing the appropriate documentation.
- Receiving, holding, and distributing funds related to the exchange.
- Advising or consulting with participants to ensure compliance with all treasury regulations and rulings.

Evaluating Performance

Investors are typically not emotional about buying decisions and like to have objective means to compare properties. Therefore, it’s necessary to have various yardsticks by which to measure the performance of the property. We’ll look briefly at three: Net operating income, capitalization rate, and cash flow.

Net Operating Income (NOI)

Net operating income (NOI) is one of the first indicators of an investment’s performance. It is the annual income from a property or business that remains after annual operating costs are paid. NOI is calculated by deducting operating expenses from effective gross income. Because property has value independent of any financing an investor might obtain to acquire it, net operating income (NOI) does not take into consideration any expenses associated with the financing of property.

NOI can either be based on historical financial statement data or on forward-looking estimates for future years, known as a proforma statement.
For Example

An investor bought a duplex for $115,200. Each unit rents for $800 a month, making the annual potential gross income $19,200 ($800 x 2 units x 12 months). She assumes a 5% vacancy/collection loss annually ($19,200 x 0.05 = $960) and has no additional income sources on the property. The annual operating expenses for the property (management, maintenance, insurance, taxes) total $9,600. To find the net operating income:

\[
\begin{align*}
\text{Potential Gross Income} & = 19,200 \\
- \text{Vacancy Rate} & = -960 \\
+ \text{Other Income} & = +0 \\
\text{Effective Gross Income} & = 18,240 \\
- \text{Expenses} & = -9,600 \\
\text{Net Operating Income} & = 8,640
\end{align*}
\]

Capitalization Rate

The most important tool that investors use to evaluate their income-producing properties is the capitalization rate, also called the cap rate. The cap rate indicates a rate of return, stated as a percentage, based on the net operating income a property generates. The capitalization calculation, also called the IRV formula, relies on three variables: Income, Rate, and Value.

- **Income.** The amount of money a property earns, the annual net operating income (NOI).
- **Rate.** The return on the purchase price of the property, the capitalization rate.
- **Value.** The value of the investment, what the investor paid to acquire it.

As with any Circle Math formula, when you know two variables, you can easily find the third:

\[
\begin{align*}
\text{Income (NOI)} \div \text{Value} & = \text{Cap Rate} \\
\text{Income (NOI)} \div \text{Cap Rate} & = \text{Value} \\
\text{Value} \times \text{Cap Rate} & = \text{Income (NOI)}
\end{align*}
\]

Recall that appraisers multiply the capitalization rate, derived from comparables in the market, by the property’s NOI to determine an estimate of value when applying the income approach to appraisal.
For Example

Using the numbers from the previous example, plug the known factors into the IRV formula to find the capitalization rate:

\[
\frac{\$8,640 \text{ (Income)}}{\$115,200 \text{ (Value)}} = 0.075 \text{ (Rate)}
\]

The investor’s capitalization rate is 7.5%. This number represents the percent of return the investor receives from the investment (again, without considering debt service). It allows the investor to evaluate whether the property is meeting her investment goals and to compare this property to other potential investment opportunities. A broader look at current cap rates in the marketplace also gives investors a window into trends, indicating where the market may be headed.

Cash Flow

Cash flow is a measurement of both income and expense items associated with operating the property. Cash flow before taxes, therefore, is the gross amount of income available before considering taxes. Positive cash flow means more money is coming in from the investment than is leaving it. Negative cash flow, then, is the opposite.

If the property was purchased with cash, cash flow would be equal to the net operating income. If the purchase is financed, however, investors must consider the effect that debt service has on cash flow. Debt service is the amount of money required for the payment of current interest and principal on a long-term debt. Debt service typically has two components:

- The interest due on the outstanding balance.
- The amortization (or reduction) of the balance by paying back some of the principal owed on a regular basis.

When annual debt service is subtracted from the net operating income, any amount remaining would be considered the cash flow.

For Example

The investor bought that duplex for $115,200, putting $34,000 down and financing $81,200 at 5%. Her monthly mortgage payment of principal and interest is $436, with an annual debt service of $5,232 ($436 x 12 ). The net operating income on the property is $8,640. To find the cash flow, subtract annual debt service from NOI:

\[
\begin{align*}
\text{Net Operating Income} & \quad 8,640 \\
\text{Debt Service} & \quad -5,232 \\
\text{Before Tax Cash Flow} & \quad 3,408
\end{align*}
\]
Cash-on-Cash Return

Cash-on-cash return, also referred to as “cash in on cash out,” is the ratio of income generated by the property to the cash investment in the property. Once the before-tax cash flow is determined, cash-on-cash return is found by dividing that number by the out-of-pocket cost to acquire the property:

\[
\text{Before Tax Cash Flow} \div \text{Acquisition Costs} = \text{Cash-on-Cash Return}
\]

For Example

Our investor made a $34,000 down payment for that duplex and paid $6,000 in closing costs. She determines a before tax cash flow of $3,408 and can calculate the cash-on-cash return as shown:

\[
\frac{3,408 \text{ (Cash Flow)}}{40,000 \text{ (Acquisition Cost)}} = 0.085 \text{ or 8.5\% (Cash-on-Cash Return)}
\]

Obviously, there are many more sophisticated calculations and analyses available to evaluate the performance of investment property, but those are beyond the scope of this chapter.

Summary

1. There are several tax deductions available that provide incentives to purchase a home. Main deductions include mortgage and home equity loan interest, and property taxes. These deductions can also be counted on a second home or vacation property, provided the home is not rented for more than two weeks during a year. Capital gains and losses are generated when a capital asset is sold. The Taxpayer Relief Act of 1997 provides an exemption from capital gains taxes for the sale of a principal residence for those who qualify. To qualify, the seller must have resided at the property for two of the last five years. This exemption can be claimed only once every two years, unless the seller has had a change in place of employment, health considerations, or unforeseen circumstances. A single person can exclude up to $250,000; a married couple filing jointly can exclude up to $500,000.

2. Real property tax is an ad valorem tax, based on the value of real property. This means the owner of more valuable property should pay more in taxes than the owner of less valuable property. Special assessment taxes are levied against specific properties to pay for infrastructure costs, such as sidewalks or street lights. Property taxes are raised locally by counties, cities, towns, villages, and school districts. Tax exemptions are commonly given to certain entities, organizations, and individuals, such as veterans, the elderly, farmers, homeowners, religious organizations, government entities, hospitals, and schools. A property’s assessed value is the value placed on land and building by a city, town, or county assessor for use in levying annual real estate taxes. The assessed value is multiplied by the tax rate to determine the property taxes.
3. A primary goal of any investor is the preservation of the capital invested. Investors trade a lump sum of capital in the present for the expectation of one or more of the following: Receiving a continuing stream of income; creating a tax shelter, which gives owners certain income tax advantages; building equity in the investment through leverage and appreciation; and earning a return on the investment when the property is sold.

4. Risk is the degree of probability the actual rate of return earned will differ from the return expected when the investment was made. Liquidity is the ability to convert an asset into cash quickly without the loss of principal. The long-term nature of commercial real estate investments makes it one of the least liquid of investments. Leverage is the effect that borrowed funds (other people's money) have on investment returns.

5. Depreciation is the loss of value to a property over the time it is expected to be useful. The Internal Revenue Service allows investors to deduct depreciation as a line item expense to reduce the taxable income. The annual depreciation is calculated by dividing the value of the improvement (not the value of the land on which the improvement sits) by the designated recovery period: 27 1/2 years for residential investment property and 39 years for other commercial property.

6. Internal Revenue Code Section 1031 allows a taxpayer to sell investment property and purchase another investment property in its place, deferring payment of capital gains taxes. Properties to be exchanged must be like-kind, for example, real property for real property. The property purchased must be of equal or greater value than the property sold, otherwise, the investor would have to pay capital gains taxes on the difference.

7. Investors use various tools to evaluate the performance of a property. A critical calculation is the net operating income (NOI), which measures the ability of an investment property to produce an income stream or cash flow from its operations. To find NOI: Gross Potential Income – Vacancy Loss + Miscellaneous Income = Effective Gross Income – Expenses = NOI. The capitalization rate indicates a rate of return, stated as a percentage, based on the NOI a property generates. Use the IRV formula to calculate the cap rate: Income (NOI) ÷ Value (sales price) = Rate (capitalization rate). Cash flow is a measurement of income and expenses associated with operating the property, including debt service. This allows an investor to find the cash-on-cash return, the ratio of income generated by the property to the cash investment in the property. Once the before-tax cash flow is determined: Cash Flow ÷ Acquisition Cost = Cash-on-Cash Return.
Chapter Quiz

1. Which list of items related to a primary residence may someone deduct from income taxes?
   A. interest paid on home equity loan, new roof, in-home office
   B. mortgage interest, losses not covered by insurance, maintenance costs
   C. mortgage interest, property taxes, in-home office
   D. mortgage interest, property taxes, losses covered by insurance

2. C and D purchased a home 25 years ago for $800,000 when they got married. They recently sold the property for $1.2 million. On what amount will they have to pay capital gains taxes?
   A. $0
   B. $150,000
   C. $250,000
   D. $400,000

3. Ad valorem refers to a tax that is
   A. based on the assessed value of property.
   B. charged by the county to transfer a deed when property sells.
   C. a percentage of a property’s sale price.
   D. a percentage of someone’s income.

4. Of these, which is MOST LIKELY to be paid for with a special assessment?
   A. new fire engine
   B. new sports stadium
   C. sewer repair
   D. teacher’s salaries

5. E bought her house for $240,000. If an assessor’s opinion is that E’s property is worth $250,000, and the statutory assessment ratio is 33.33%, what is the assessed value of her property?
   A. $79,200
   B. $79,992
   C. $82,500
   D. $83,325

6. The property tax rate in Bigtown is 1.7% of assessed value. Which is NOT an acceptable alternative way to express this tax rate?
   A. $1.70 per $100
   B. $17.00 per $1,000
   C. $170.00 per $1,000
   D. 17 mills

7. A property is appraised at $250,000 and assessed for tax purposes at 40% of value. What are the quarterly taxes if the tax rate is $60 per $1,000?
   A. $600
   B. $1,500
   C. $6,000
   D. $12,000

8. What tax rate was used for a property with an assessed value of $148,900 that owes $8,200 in taxes?
   A. 0.055 mills
   B. 5.5 mills
   C. 55 mills
   D. 55%

9. Property in town is assessed at 50%. The property tax rate is $18 per $1,000. If an owner’s annual taxes are $720, what is the market value of his property?
   A. $40,000
   B. $80,000
   C. $90,000
   D. $130,909

10. M purchases a new home for $300,000. He makes a 20% down payment. What is M’s equity in his new home?
    A. $0
    B. $60,000
    C. $240,000
    D. $300,000
11. An investor buys a vacant lot for $64,500. He splits it into two lots and sells them for $37,200 each. What is his percent of profit?
   A. 8.6%
   B. 11.5%
   C. 13.3%
   D. 15.3%

12. A homeowner bought a house for $278,000. She sold it nine years later for $264,000. What is her percent of loss?
   A. 3.9%
   B. 5.0%
   C. 5.3%
   D. 9.5%

13. Residential rental property can be depreciated over _______ years.
   A. 15
   B. 27 1/2
   C. 31 1/2
   D. 39

14. J has his investment dollars tied up in a number of different outlets. He's bored with his portfolio and wants to find something new that interests him. Of these, which would LEAST LIKELY be an exchange that would allow him to defer capital gains taxes?
   A. a beet farm for a silver mine
   B. a plane for a sculpture
   C. a shopping mall for an apartment building
   D. a stallion for a mare

15. Investor B borrows money from a bank to purchase a small office building. She is able to make the mortgage payments from the rent generated by the leases and still realize a profit. This is an example of what financing concept?
   A. appreciation
   B. leverage
   C. liquidity
   D. marketability

16. As Y gets older, he begins looking for an investment property that is lower maintenance than the apartment building he currently owns. He's thinking about buying a small medical office building instead. What is the primary reason Y should consider a like-kind exchange?
   A. He can avoid paying commission on the sale of the apartment building if he buys another property.
   B. He can avoid transfer taxes on the purchase of the medical office building.
   C. He can defer capital gains taxes on the sale of the apartment building by reinvesting.
   D. He can defer income taxes on the cash flow produced by the medical office until he sells it.

17. R owns a small strip mall with a market value of $350,000. The land on which it sits is valued at 45%. What is the total amount that R will be able to deduct next year as depreciation?
   A. $3,808
   B. $4,038
   C. $4,654
   D. $4,936

18. An investor buys a duplex for $208,000. Each unit rents for $950 a month. The property has a 5% vacancy and annual operating costs of $4,200. What is the capitalization rate on this property?
   A. 8.4%
   B. 8.6%
   C. 10.9%
   D. 11.9%

19. The operating statement on K's rental property shows an effective gross income of $48,750 and a net operating income of $28,000. She pays $2,900 a year for insurance, $7,000 a year for property taxes, and $15,600 a year on her mortgage. What is the before-tax cash flow?
   A. $2,500
   B. $12,400
   C. $18,100
   D. $23,250
20. J buys a four-unit apartment building. He put 10% down on a purchase price of $500,000. Based on his financing terms, the monthly principal and interest is approximately $2,700. The NOI is $35,000 annually. What is the cash-on-cash return?

A. 4.4%
B. 5.2%
C. 6.5%
D. 8.8%
Ethics refers to a higher system of beliefs, principles, rules, and standards based on values. Business ethics establishes rules that strive for a simple principle of doing what is right. Real estate licensees should be expected to maintain high standards of professional conduct in their dealings with the public and with other licensees. It’s equally important to avoid any activities that, while not specifically illegal or unethical, give the appearance of impropriety.

After reading this chapter, you will be able to:

- Define ethics and discuss its application to real estate professionals.
- Identify actions or statements that violate antitrust laws.
- Describe consumer protection provisions of federal law.

**Key Terms**

Actual Fraud
Antitrust
Bait and Switch
Blind Advertisement
Boycott
Cease and Desist Order
Code of Ethics
Constructive Fraud
Established Business Relationship (EBR)
Ethics
Market Allocation
Misrepresentation
National Do Not Call Registry
Negligence
Opt Out
Price-Fixing
Puffing
Spam
Tie-In Agreement
Misrepresentation and Fraud

Real estate licensees have a duty to protect the public against fraud, misrepresentation, and unethical practices. Sadly, violations by licensees often take some form of misrepresentation. Misrepresentation is simply false or misleading information. Misrepresentation could involve any of the following:

- Documents, such as an altered pay document or false information on applications
- Misstatements, such as telling a buyer a property is three acres when it is not
- Omission, which is failing to mention or disclose information

When a misrepresentation is made to a consumer with the intent to deceive, it is a form of fraud and can result in prosecution. Note that written disclosures or fine print may not necessarily be sufficient to correct a misleading representation.

Fraud

Fraud is a deliberate act with the intent to deceive or with reckless indifference to the truth. It is any form of deceit, trickery, breach of confidence, or misrepresentation by which one party attempts to gain some unfair or dishonest advantage over another. Failing to disclose information you’re required to disclose can be a form of fraud. Fraud also includes actively concealing information and making false or misleading statements. Fraud falls into two broad categories, actual fraud and constructive fraud. Any type of fraud may constitute grounds for possible civil action for damages.

Actual Fraud

Actual fraud is an intentional misrepresentation or concealment of a material fact. Actual fraud is also when a person actively hides information or makes statements known to be false or misleading. When any of these is done with an intent to deceive, it constitutes actual fraud.

For example, if the seller’s agent advises the sellers to paint their basement before showing the home to hide the smell of mold, and neither the licensee nor the homeowner discloses the mold problem, both are guilty of fraud.

Constructive Fraud

Constructive fraud is a negligent misrepresentation or concealment of a material fact. When information is not disclosed or false statements are made unintentionally, it may be considered constructive fraud. Here, the false statements or failure to disclose is the result of carelessness or negligence, rather than intent to deceive. This is also called negligent misrepresentation. When claiming fraud or deception, the victim may not need to prove he was harmed financially in the transaction or relied upon such misstatement, misrepresentation, or omission to make a decision in the transaction.

From a legal perspective, the misrepresentation of a material fact could give someone grounds to rescind a contract. A material fact is generally defined as one that, if known, might have caused a reasonable person to make a different decision.
Examples of Fraud

There are various ways one can commit fraud:

- **Concealment** occurs when a licensee fails to disclose information that is material to a decision to a party to whom the licensee has such a duty. Typically, a licensee must disclose any fact, report, or rumor concerning the transaction to the principal. If the licensee is aware of the ignorance of a customer about a subject, the licensee may have a duty to speak as well.

- **Collusion** occurs when someone schemes with another with the intent to defraud a third party.

- **Commingling** occurs when a licensee mixes client funds with brokerage funds.

- **Culpable negligence**, like negligent misrepresentation, occurs if a licensee operates in a reckless, careless, and excessively negligent manner. Culpable negligence is negligence for which one can be held legally accountable.

- **Conversion** occurs when a licensee uses or makes available someone else’s funds or property for their own personal or business use.

- **Failure to account** is a form of conversion that occurs when a licensee is required to produce money or property belonging to another in the normal course of business and either cannot or will not produce it.

- **Filing false documents** or unauthorized documents in the public record such as liens, contracts, or deeds is a form of fraud.

- **False or misleading advertising** occurs when one disseminates or causes to be disseminated any false or misleading information by any means for the purpose of offering any real estate for sale, lease, or rent.

Actionable Fraud

Fraud is said to be actionable when certain elements are present. To sue for actual or constructive fraud, the plaintiff must be able to prove all five elements:

1. The person makes a false statement about a material fact or conceals a material fact he has a legal duty to disclose.
2. The person makes a statement she knows or should know is false.
3. The person makes a statement or concealment with the intent to induce another to enter into a transaction.
4. The other person relies on the statement, or lack of knowledge of the concealed information, and is induced to enter the transaction.
5. The other person is harmed as a result of entering the transaction.

A real estate licensee is NOT required to verify everything a seller says, but if something suggests the seller’s claims may be false, a licensee who does not make reasonable efforts to ascertain the facts could be considered negligent and held liable.
Opinions and Puffing

**Puffing** is an exaggeration about the quality of a property that may be difficult to back up with proof. For example:

- “Compared to the sales prices for other homes in the neighborhood, this one appears to be an excellent buy.” *(Opinion)*
- “This remodeled kitchen will turn you into a gourmet chef!” *(Puffing)*

To prove fraud based on a false statement, it’s necessary to show that the person relied on the statement. Because of their nonfactual or exaggerated nature, opinions and puffing are not generally considered the type of statements that a reasonable person would rely on when making a purchase decision. As such, they do not generally fall under the fraud category.

However, real estate licensees should be cautious about stating unsubstantiated opinions. In special circumstances, **opinions may be actionable**. A court may allow recovery based on opinions stated by an expert hired to give advice or a person who has superior knowledge and is acting in a fiduciary relationship. Someone who states an opinion that he doesn’t believe could be held liable.

Liability

A licensee is generally **not liable** to any party for false information that the licensee’s client provided to the licensee and the licensee in turn provided to another party in the transaction unless the licensee had **actual knowledge** that the information was false or the licensee acted with **reckless disregard for the truth**.

It is important to note, however, that a **broker** is generally **legally liable** for the acts of affiliated licensees and employees if the actions are **within the scope of their relationship**, regardless of whether broker knew about the actions or not.

Truth in Advertising

In the zeal to show off a unique, difficult, or underappreciated property, a licensee often attempts to embellish a home’s good qualities and disguise a home’s bad features. The line between misrepresentation and harmless exaggeration can seem very thin at times. Licensees have a legal and ethical obligation to present a **true picture** in all their advertising. The requirement to be honest and truthful relates to **ALL aspects** of a real estate professional's dealings with consumers, including:

- Advertising services and property in any medium (television, radio, print, Internet, etc.)
- Disclosing ownership interest or licensee status in advertising and other communication
- Maintaining accurate and current information on websites
- Refraining from practices that could mislead, misdirect, or confuse consumers on websites

Deceptive and Unfair Ads

Any advertisement for property that is placed by a licensed real estate professional should be truthful and should not mislead a potential customer simply to lure them into looking at a property.
The Federal Trade Commission Act of 1914 allows the Federal Trade Commission (FTC) to act in the interest of all consumers to prevent deceptive and unfair acts or practices. According to the FTC Act, truth in advertising rules apply to anyone who places an ad. Under the act,

- Advertisers must have evidence to back up their claims.
- Advertisements cannot be unfair.
- Advertising must be truthful and not deceptive.

When determining if the practice is likely to be deceptive, the FTC will examine it from the perspective of a consumer acting reasonably in the circumstances, reviewing the entire advertisement, transaction, or course of dealing. Rather than focusing on certain words, the FTC looks at the ad in context—including words, phrases, and images—to determine what it conveys to consumers.

If the representation or practice affects or is directed primarily to a particular group, such as the elderly, the FTC examines reasonableness from the perspective of that group.

Examples of deceptive and misleading advertising could include:

- Advertising a property that is subject to an exclusive listing agreement with a sponsoring broker other than the licensee’s own without the permission of and identifying that listing broker.

- Failing to remove advertising (signage, print, electronic, etc.) of a listed property within a reasonable time after the closing of a sale on the listed property or after the expiration or termination of the listing agreement, whichever circumstance is earlier.

- Advertising a property at auction as being without reserve, when there is a minimum bid or opening bid required.

- Advertising a property in a manner that creates a reasonable likelihood of confusion regarding the permitted use of the property. Examples of such advertising would be advertising a property zoned single-family as appropriate for multi-dwelling use by using words or phrases such as “apartment,” “two units,” or “separate living arrangement” unless that use is permitted by the zoning ordinance, a variance from the zoning ordinance, a conditional permitted use, or an existing legal non-conforming use.

**Bait and Switch**

The Federal Trade Commission also addresses the illegal practice of **bait and switch**. This occurs when an advertiser makes an alluring but insincere offer to sell a product or service that the advertiser, in truth, does not intend or want to sell. The intent is for consumers to switch from buying the advertised product or service to buying something else, usually at a higher price or in some way more advantageous to the advertiser.

**Blind Advertisements**

A **blind advertisement** is any real estate advertisement used by a licensee that does not include the broker's business name. Most states prohibit blind advertisements, as they could mislead consumers into thinking that the property is for sale by owner.
REALTOR® Code of Ethics

The National Association of REALTORS® is a professional organization that, in 1913, created one of the first written codes for ethical conduct in any industry. The Code of Ethics and Standards of Practice of the National Association of REALTORS® contains statements intended to advise, guide, and regulate behavior while working in the world of real estate. When real estate professionals voluntarily choose to join the National Association of REALTORS®, they agree to abide by the NAR Code of Ethics.

The Code of Ethics contains three sections, each of which is comprised of articles, which are statements of ethical philosophies. Each article has specific standards of practice that support, interpret, and strengthen each article and to which a REALTOR® is expected to adhere.

Several articles in the REALTOR® Code of Ethics deal with competency. Licensee competency can be applied in many ways. The most general understanding is that licensees should not take on a client or a task for which they have not been properly trained. The key is to know one's limitations, be honest with clients and customers, get assistance when needed, and make references as necessary.

Duties Owed to Customers and Clients

- **Article 1:** REALTORS® must pledge to protect and promote the interests of their client and reminds members that while the obligation to the client is primary, it does not diminish the obligation to treat all parties honestly.

- **Article 2:** REALTORS® must avoid exaggeration, misrepresentation, or concealment of pertinent facts relating to the property or the transaction, with a reminder that REALTORS® are not required to discover latent defects in the property, to advise on matters outside the scope of their real estate license, or to disclose facts that are confidential.

- **Article 3:** REALTORS® must cooperate with other brokers unless it is not in the client's best interest.

- **Article 4:** REALTORS® must disclose any ownership interest they have in the property and must disclose their licensee status in property transactions.

- **Article 5:** REALTORS® must disclose any present or contemplated interest in a property for which they would provide professional services.

- **Article 6:** REALTORS® shall not accept any commission, rebate, or profit on expenditures made for their client, without the client's knowledge and consent.

- **Article 7:** In a transaction, REALTORS® shall not accept compensation from more than one party, even if permitted by law, without disclosure to all parties and the informed consent of the REALTORS®' client or clients.

- **Article 8:** REALTORS® shall keep in a special account in an appropriate financial institution, separated from their own funds, monies coming into their possession in trust for other persons, such as escrows, trust funds, clients' monies, and other like items.

- **Article 9:** REALTORS®, for the protection of all parties, shall assure whenever possible that all agreements related to real estate transactions are in writing in clear and understandable language expressing the specific terms, conditions, obligations, and commitments of the parties. A copy of each agreement shall be furnished to each party to such agreements upon their signing or initialing.
Duties Owed to the Public

- **Article 10**: REALTORS® must follow all anti-discrimination laws that protect people on the basis of race, color, religion, sex, handicap, familial status, national origin, sexual orientation, or gender identity.

- **Article 11**: REALTORS® must conform to the standards of practice and competence that are reasonably expected in their specific real estate disciplines. It prohibits REALTORS® from attempting to provide specialized professional services that are outside their field of competence unless they engage the assistance of professional or unless they disclose their experience to the client.

- **Article 12**: REALTORS® must be honest and truthful in their real estate communications and must not make any misrepresentation in advertising, marketing, and other representations, including disclosure of their licensee status.

- **Article 13**: REALTORS® must never engage in activities that would be considered an unauthorized practice of law, but should recommend that legal counsel be obtained as necessary.

- **Article 14**: REALTORS® must follow the NAR’s process for answering charges of violations or unethical behavior, and must also cooperate with any professional standards proceeding or investigation.

Duties Owed to Other REALTORS®

- **Article 15**: REALTORS® shall not knowingly or recklessly make false or misleading statements about competitors, their businesses, or their business practices.

- **Article 16**: REALTORS® shall not engage in any practice or take any action inconsistent with exclusive representation or exclusive brokerage relationship agreements that other REALTORS® have with clients.

- **Article 17**: If a REALTOR® has a dispute with another REALTOR®, he should submit the dispute to arbitration instead of litigating the matter. Furthermore, the REALTORS® must agree to abide by the arbitration decision.

REALTORS® are subject to disciplinary action and sanctions separate from any penalties that may be imposed by a state if they violate the duties imposed by the Code of Ethics.
The Unauthorized Practice of Law

Many aspects of real estate transactions raise legal questions or have legal consequences. Real estate licensees need to remind their clients and customers that they are not licensed to practice law. **Licensees should never give legal advice or perform any acts that require an attorney’s expertise.**

A real estate licensee is generally permitted to complete standard listing forms and approved, preprinted purchase agreement forms. In most states, a licensee is not permitted to draft an original agreement or add complicated clauses to forms. That may be considered an unauthorized practice of law.

Courts have held that licensees who engage in the unauthorized practice of law may be subject to disciplinary action, including license suspension or revocation.

It is recommended that any document or contract prepared by a real estate licensee include a statement that the document is subject to the review of an attorney. This statement could protect the licensee and the brokerage from being charged with unlawful practice. Another way to mitigate potential problems is to use standard forms from local real estate associations or bar associations.

Antitrust

**Antitrust** is a business activity that attempts to monopolize, contract, or conspire (or any of these things together) in a way that negatively impacts another's ability to do business. Federal antitrust laws regulate business activities in general, concluding that any **restraint of trade** practices are so injurious to competition that they could never be justified as anything but unreasonable and, therefore, illegal.

Federal Laws

Believing that fair competition was necessary for the economic health of the country, the federal government began to consider laws to outlaw monopolies and rein in unfair business practices that occurred after the Civil War. The activities prohibited by the following laws continue to be addressed via the U.S. Department of Justice through court decisions.

The Sherman Antitrust Act

The **Sherman Antitrust Act** of 1890 was the first federal law outlawing practices considered harmful to consumers, such as monopolies. At the time, large corporations accused of anticompetitive practices were organized as trusts, hence the name of the act. Of primary concern with this law is **collusion** between people or organizations to limit competition, set artificial price controls, or—through fraud or misrepresentation—attempt to gain an unfair advantage. A conspiracy can involve as few as two competing members of the same trade.

Clayton Antitrust Act

Congress passed the **Clayton Antitrust Act** of 1914 to enhance the Sherman Antitrust Act by prohibiting specific anticompetitive practices. For example, it bans mergers and acquisitions as well as price discrimination that lessens competition and creates a monopoly in any line of commerce. It also provides for more stringent penalties to businesses who do not abide by these laws.
The Clayton Act also authorizes private parties to sue for damages when they have been harmed by conduct that violates either the Sherman or Clayton Act. This can lead to a court order prohibiting the business from continuing such anticompetitive practices.

**Federal Trade Commission Act**

The Federal Trade Commission Act was passed in 1914, creating the Federal Trade Commission (FTC) as the nation’s consumer protection agency. At the time, its purpose was to prevent unfair methods of competition in commerce. Over the years, Congress passed additional laws giving the agency greater authority to police anticompetitive practices. For example, the FTC is the enforcer of the Clayton Act and, in 1938, Congress passed a broad prohibition against “unfair and deceptive acts or practices.” Since then, the Federal Trade Commission also has been directed to administer a wide variety of other consumer protection laws.

**Prohibited Practices**

Certain activities are considered illegal under federal antitrust laws, and, therefore, are presumed to be an unreasonable restraint on trade regardless of intent.

**Price-Fixing**

Antitrust problems most frequently arise out of agreements—conspiracies, really—among competitors that eliminate or restrict competition between them. A common subject of such agreements is the price or fee each competitor charges its customers for its products or services. Real estate brokerage firms are no different, and in the real estate profession, that usually means commission rates.

The antitrust prohibition on fixing commission rates means, simply, **two or more competing real estate firms may not agree on the commission rate that each will charge**. Brokers must not agree with other brokers on commission rates and must take care to avoid even implying that they have discussed and/or reached agreement on fees. Licensees must exercise similar caution to avoid the implication that the firm with which they are affiliated is part of a price-fixing conspiracy. Think carefully before discussing commissions.

**For Example**

You can tell a licensee from another agency what your brokerage split is with her brokerage. “If you sell my listing, I’ll give you 3% of the sales price.” That’s OK, because the other broker needs to know how much the brokerage is going to make. But it is illegal to say, “I charge 6% commission.” It’s not the other brokerage’s business. The antitrust laws are so emphatic when it comes to price-fixing in real estate that real estate licensees may not have any discussion whatsoever about commission rates with other brokerage representatives.

Never use the words “standard,” “average,” or “going rate” when presenting your firm’s commission to a potential client.
Market Allocation

Two or more licensees from different brokerage firms cannot divide prospective clients and customers in any way. This is considered market allocation and is a violation of antitrust laws because it limits competition. Licensees from different brokerages cannot, for example, split their city into specific territories or agree to handle only properties within a certain price range or neighborhood. Even if the agreement seems logical, these actions could result in a restraint on trade because they limit the choices of the consumer, which is illegal.

Tie-In Agreement

A tie-in agreement, also called a tying agreement or tie-in arrangement, results when someone tries to make one transaction or agreement contingent on a second transaction or agreement. For example, a buyer has a buyer-brokerage agreement to find a house. The contract contains a statement that the buyer agrees to list the new house with the brokerage when he decides to sell it. The buyer might sign the buyer-brokerage agreement, but the broker can’t hold him to that secondary agreement—it’s an illegal tie-in. Another example of an illegal tie-in occurs when a brokerage forces a client or customer to use a specific service provider. While it is legal to own a real estate brokerage and an insurance company or home inspection company, for example, you may not force the use of that service on any buyer or seller. If a brokerage does recommend the use of specific providers, the key is disclosure.

Boycotting

A boycott is a concerted refusal to deal with a particular party, such as when two or more businesses agree to refuse to deal with another competitor in order to force a change in a competitor’s behavior or to attempt to drive the competitor out of business. The typical group boycott allegation in the real estate brokerage business involves a claim that two or more real estate firms have agreed to refuse to cooperate, or to cooperate on less favorable terms, with a third firm. Often the target of the alleged boycott is a broker that employs a “discount,” “alternative,” or other nontraditional commission/compensation arrangement with clients.

The purpose of the boycott, either explicitly or implicitly, is to eliminate the firm as a competitor in the market or to cause the firm to abandon the discount or alternative marketing strategies.

Disparaging the Competition

Sharing false, misleading, or negative comments about a competitor to a client, customer, or fellow licensee is, at best, gossip and, more seriously, could result in disciplinary action or lawsuits. An untruthful spoken statement about a person that harms his reputation or standing in the community, while not considered illegal per se, could be considered slander, and the slandered person could bring a civil lawsuit against the person who made the false statement under the Clayton Antitrust Act if such statements negatively affected that person’s business.
Antitrust Phrases to Avoid

Price-Fixing
- “This is the rate every firm in town charges.”
- “I’d like to lower the commission, but no one else in the MLS will show your house unless the commission is X%”
- “Commission rates are generally standard.”
- “This is the average commission rate being charged these days.”

Market Allocation
- “It could save us both a lot of gas if your firm would concentrate on the north side and ours concentrated on the south side.”
- “This is my neighborhood. Tell them to go someplace else.”
- “We’ll take the million-dollar listings since we’re equipped to handle them, and you concentrate on the starter homes.”

Tie-In Agreements
- “If I’m going to submit an offer for you, I need you to use XYZ Home Inspectors.”
- “I only work with ABC Insurance Company, so you need to call them before we proceed.”

Boycotting
- “We should not be working with ABC Realty because they charge a flat fee.”
- “I bet they’d drop their ‘discount’ program if we told them they couldn’t market or sell our listings.”

Disparagement
- “Before you list with XYZ Realty, you should know that nobody works on their listings.”
- “You don’t want to list with ABC Realty; they don’t know how to close a deal.”
- “If they were truly professional, they would not allow part-timers to work for them.”

Enforcement

The U.S. Department of Justice (DOJ) and the Federal Trade Commission may file civil lawsuits against violators of federal antitrust laws, while a state’s attorney general may file civil suits to enforce both state and federal law. Initial responses to a civil suit may include

- **Cease and desist orders**, which are administrative agency directives to stop the offending activity.
- **Injunctive relief**, which is a court-ordered prohibition against a particular act, as opposed to a judgment for money, often imposed for violating a cease and desist order.

The DOJ and the FTC are not the only ones who can file antitrust lawsuits. Anyone whose business or property has been injured by someone violating antitrust laws may file a **private civil lawsuit** in state or federal court. If the court finds against the defendant, the plaintiff could recover **triple** the damages, plus any reasonable attorney fees.
Criminal Penalties
Violating a state or federal antitrust law is a serious offense, as anyone convicted of these violations is guilty of a criminal felony and could be sentenced to jail time. In addition, the fines for antitrust violations are particularly steep. Penalties under federal statutes include the following:

- Felony conviction
- Fines not to exceed $350,000 for individuals or $10 million for corporations
- Imprisonment not to exceed three years

Only the U.S. Department of Justice can file criminal charges for federal antitrust violations.

Since any violation of antitrust laws is considered a criminal offense, errors and omissions insurance or liability insurance cannot protect an offender.

Real Success
Antitrust is a fairly complicated subject and applies to many industries and professions. The nature of real estate practice makes real estate licensees particularly susceptible to antitrust challenges. Licensees vigorously compete to secure property listings to offer for sale, but they also regularly cooperate with one another to identify ready, willing, and able buyers for those listings.

This dual tradition of competition and cooperation, which exists in few other professions, presents opportunities for antitrust misconduct, whether intentional or inadvertent. When engaging in real estate, you must never behave in such a way as to limit the consumer’s choices.

The final word of advice for real estate licensees. Never take part in an event, meeting, or even informal conversation where the discussion can be construed as an antitrust violation. You should not remain in a situation where suggestions of price-fixing, group boycotts, market allocation agreements, or tie-in arrangements are being discussed or even being subtly suggested. You may choose to openly object to this type of conversation, but at the very least, you should physically remove yourself from the situation. Most often, silence is not a defense in an antitrust accusation. Failure to act can potentially put you and your broker at the core of wrongdoing. And remember that a broker will likely bear liability for any potential antitrust violation by associated licensees.
## Challenge Activity

### Antitrust Awareness

Review each situation and determine whether it might be an antitrust violation. If so, which type of violation (price-fixing, boycotting, market allocation, tie-in arrangement, or disparagement) could it be?

<table>
<thead>
<tr>
<th>Situation</th>
<th>Antitrust?</th>
<th>Type of Violation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. M, a so-called “discount” broker, advertises his commission rate in the newspaper and on his website.</td>
<td>Yes, No</td>
<td></td>
</tr>
<tr>
<td>2. K and R are licensees for different brokerages in Anytown. One day over lunch, they agree that XYZ Discount Real Estate is really hurting their commission earnings, so they decide not to show his listings to buyers.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>3. A local real estate board publishes a suggested commission schedule, but it does not mandate that members follow it.</td>
<td>Yes, No</td>
<td></td>
</tr>
<tr>
<td>4. On a listing appointment, salesperson S tells the sellers that she guarantees she’ll sell their house, but they need to use Gorgeous Home Staging Inc. to come in and get the home ready for showing before she’ll list it.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>5. Next House Realty has been doing business in town for years. When High Street Realty opens, F, a salesperson at Next House, tells prospective clients that High Street’s agents don’t know the neighborhood and can’t possibly price their homes correctly.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>6. H and K are both sales agents for Northwoods Realty. At a company meeting, broker B told them not to accept any listing for less than 7%.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>7. O of Rock Realty tells P of Happy Realty that he will reject any listing south of Highway 1 if P will reject any listing north of Highway 1.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>8. A local multiple listing service refuses to accept listings from any agency that charges a flat fee.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>9. At a convention for the area’s real estate brokers, broker T mentions that he’s thinking of raising the commission rate his brokerage charges to 7.5%.</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>10. G buys a new condo through Resort Realty. When he signs the papers at closing, he sees a clause in the contract indicating that if he ever decides to sell the condo, he must list with Resort Realty.</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>
Consumer Protection Laws

Licensees have a fiduciary obligation to clients to keep any information gathered as part of a real estate transaction confidential. Licensees also should be sensitive to the potential nuisance of unwanted solicitations and the unauthorized use or sharing of private information. There are a number of federal laws that address issues related to the protection of a consumer’s personal information. While not specifically directed at real estate transactions, it’s helpful to be at least familiar with some of the provisions of these laws.

National Do Not Call Registry

The National Do Not Call Registry (DNC) is a provision of the federal Telemarketing Sales Rule. Consumers can request not to be called by commercial telemarketers by adding their name and number to the registry. The DNC Registry is managed by the Federal Trade Commission and enforced by the FTC, the Federal Communications Commission (FCC), and state law enforcement officials.

The National Do Not Call Registry applies to any plan, program, or campaign to sell goods or services through interstate phone calls. This includes telemarketers who solicit consumers, often on behalf of third-party sellers. It also includes sellers who provide, offer to provide, or arrange to provide goods or services to consumers in exchange for payment. The DNC Registry does not limit calls by political organizations, charities, or telephone surveyors.

Many states have their own, often more stringent, “do not call” laws. Make sure you’re familiar with the laws in the jurisdictions in which you practice.

Call Lists

To keep from violating DNC regulations, a company must maintain national and internal lists of customers and prospects who do not want to be called and keep the lists updated regularly:

- The National DNC list must be updated every three months.
- The internal do not call list must be updated every 30 days.

Anyone who receives a telemarketing call to a phone number registered on the list may file a complaint with the FTC. The FTC, FCC, or states attorney generals could also instigate an investigation. Those who violate the National Do Not Call Registry or place an illegal robocall can be fined up to $40,654 per call.

Established Business Relationship

A telemarketer or company may call a consumer with whom it has an established business relationship (EBR) for up to 18 months after the consumer’s last purchase, delivery, or payment, even if the consumer’s number is on the National Do Not Call Registry. In addition, a company may call a consumer for up to three months after the consumer makes an inquiry or submits an application to the company. Obtaining the name, phone number, and signature from a consumer provides written consent that does not expire until rescinded.
If a consumer asks to be put on a company’s internal do not call list, the company may NOT call to solicit new business, even if there is an EBR. Calls may be made only in reference to a current relationship, such as a licensee following up on a showing.

**CAN-SPAM**

Congress enacted the federal CAN-SPAM Act (Controlling the Assault of Non-Solicited Pornography and Marketing) to curb the annoying and costly problem of unsolicited commercial e-mail, or spam, to both computers and wireless devices without prior permission. The Act covers what the law defines as “any electronic mail message the primary purpose of which is the commercial advertisement or promotion of a commercial product or service.” This includes e-mails that promote properties on real estate websites. The law makes no exception for business-to-business e-mail.

The Act requires that marketing messages include a clear and conspicuous explanation of how the recipient can opt out of receiving e-mail. The sender must:

- Process opt-out requests for at least 30 days after sending the message.
- Honor a recipient’s opt-out request within 10 business days.

The sender may not charge a fee, require personally identifying information beyond an e-mail address, or make the recipient take any step to opt out other than sending a reply e-mail or visiting a single webpage.

The CAN-SPAM Act establishes tough penalties for violations, with fines up to $16,000 for each e-mail violation.

**FACT Act**

The federal Fair and Accurate Credit Transaction Act of 2003, referred to as either the FACT Act or simply FACTA, amended the federal Fair Credit Reporting Act and is intended primarily to help consumers fight the crime of identity theft. The FACT Act focuses on accuracy, privacy, limits on information sharing, and new consumer rights to disclosure.

To protect the privacy of consumer financial information, one provision of the FACT Act requires businesses to take measures to responsibly secure and dispose of sensitive personal information. Reasonable methods for security and disposal include the following:

- Burning or shredding papers that contain consumer report information so that information cannot be reconstructed
- Destroying or erasing electronic files or media so that information cannot be recovered or reconstructed
- Placing all pending transaction documents in locked desks, cabinets, or storage rooms at the end of the workday
Gramm-Leach-Bliley Act

The Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act, includes provisions to protect and regulate the disclosure of consumers’ personal financial information. These regulations apply to financial institutions, which include not only banks, securities firms, and insurance companies, but also companies providing many other types of services to consumers, including residential real estate settlement services.

The Financial Privacy Rule governs the collection and disclosure of customers’ personal financial information—known as nonpublic personal information—restricting when and under what circumstances such information may be disclosed to affiliates and to nonaffiliated third parties.

The Safeguards Rule requires all financial institutions and any institution that receives customer information from a financial institution to design, implement, and maintain safeguards to protect customer information while it is in the custody and control of the institution and its agents. This includes:

- Ensuring the security and confidentiality of customer records.
- Protecting against any anticipated threats or hazards to the security of such records.
- Protecting against the unauthorized access or use of such records or information in ways that could result in substantial harm or inconvenience to customers.

Real Success: Ensuring Confidentiality

Failure to protect the privacy and confidential personal information of consumers can have serious consequences. Consider the following strategies:

- **Get it in writing.** To eliminate any confusion regarding confidential information, licensees should always request in writing from the client what he can disclose when negotiating and/or marketing the home. This information should be discussed prior to entering into a brokerage agreement.

- **Secure office files.** Each agent should maintain a file on each client in a safe place that cannot be viewed by other clients or licensees. It is wise to keep files inside of a locked file cabinet and not place files with confidential information in a general office file. Any incoming faxes should be received by an administrative assistant or office manager. The original copies of faxes should never be left on the fax machine where others could view confidential information.

- **Protect messages and computer records.** All computer documents should be password-protected. Passwords should not be shared, and password confidentiality should extend to password protection of any multiple listing services, computer logins, file access, etc.

- **Maintain a professional environment.** Client confidential information should not be shared with other employees in the brokerage office unless the client gives permission. Office meetings involving confidential information should always take place in private to ensure that information is not overheard.

- **Meetings and conversations with clients.** All meetings should be held in a designated private area. While on the telephone with clients, licensees should never use a speakerphone unless the conversation is taking place in a private room.

Remember that the fiduciary duty of confidentiality survives the agency relationship and remains intact even after the transaction is completed.
Summary

1. Real estate licensees have a duty to protect the public against fraud, misrepresentation, and unethical practices. A broker is generally legally liable for the acts of affiliated licensees and employees. **Actual fraud** is an intentional misrepresentation or concealment of a material fact. **Constructive fraud** is a misrepresentation or concealment of a material fact due to negligence. **Puffing** is an opinion that is not necessarily intended as fact; it is not considered to be misrepresentation.

2. Licensees should never give legal advice or perform any acts that require a lawyer’s expertise. Licensees can often use standardized forms from real estate or bar associations, but they cannot draft an original agreement or add complicated clauses to forms. That may be considered an **unauthorized practice of law**.

3. Members of the National Association of REALTORS® are required to abide by the **Code of Ethics and Standards of Practice**. The Code contains three sections: Duties owed to clients and customers, Duties owed to the public, and Duties owed to other REALTORS®.

4. **Antitrust** is a business activity that attempts to monopolize, contract, or conspire (or any of these things together) in a way that negatively impacts another’s ability to do business. Antitrust laws are passed to fight for fair competition and fight against intimidation, economic threats, and other unsavory business practices. Federal laws addressing restraint of trade include the **Sherman Antitrust Act of 1890**, the **Clayton Antitrust Act of 1914**, and the **Federal Trade Commission Act of 1914**. Antitrust laws apply to real estate brokerages that collude with other brokerages. Antitrust violations include **price-fixing**, **market allocation**, **boycotting**, and **tie-in agreements**. Violators can face civil lawsuits and criminal penalties.

5. Several federal laws protect the privacy and personal information of consumers. The **National Do Not Call Registry** allows consumers to add phone numbers to a do not call list that prohibits calls from commercial marketers. The **national** list must be updated every **three months**; the **internal** list must be updated every **30 days**. Businesses may contact consumers with whom they have an **established business relationship (EBR)** for up to **18 months**. The **CAN-SPAM Act** is intended to curb unsolicited commercial e-mail. It gives recipients the right to **opt out** of receiving e-mails. Senders must honor opt-out requests **within 10 business days**. The **Fair and Accurate Credit Transaction Act** requires businesses to secure and dispose of sensitive personal information. The **Gramm-Leach-Bliley Act** protects the disclosure of a consumer’s personal financial information.
Chapter Quiz

1. J is being transferred. Using the ABC Realty website to look at photos of listed houses, he makes an offer on one. The seller accepts and settlement is handled with a long-distance conference call. When J arrives in town, nothing looks familiar. ABC determines that its website was linking to photos of another house. This could best be described as an example of
   A. actual fraud.
   B. bait and switch.
   C. culpable negligence.
   D. puffing.

2. A buyer’s agent has actual knowledge of structural damage to the floorboards of a home due to termite infestation. He informs his client that there are no termites in the home. The buyer signs a contract to purchase the property. Could the licensee be susceptible to claims of fraud?
   A. Yes. He knowingly made an untrue statement that could be seen as an inducement to buy.
   B. Yes, unless there are visible signs of termites, in which case the buyer should have recognized it.
   C. No, because he is protected by the “as is” clause in the purchase agreement.
   D. No, because he said there were no termites, which could be true at present.

3. Which of these situations would LEAST LIKELY be considered an example of fraud?
   A. A buyer’s agent knew her client used doctored W-2s to apply for a mortgage loan.
   B. A licensee advertised a lower list price to get interested buyers through the door.
   C. A listing agent did not disclose that his seller clients were getting divorced.
   D. A listing agent did not tell the buyer about a lien on the property she had listed.

4. Of these, which is MOST LIKELY to be considered an example of puffing?
   A. “Beautifully-maintained colonial located in historic district”
   B. “Charming country estate on 5 acres”
   C. “Great bargain on the most prestigious street in town”
   D. “Stunning lakefront views from this modern condominium”

5. Which is NOT one of the sections in the REALTOR® Code of Ethics?
   A. Duties Owed to Clients and Consumers
   B. Duties Owed to Other REALTORS®
   C. Duties Owed to the Public
   D. Duties Owed to Real Estate Licensees

6. A licensee maintains several websites, each directed at various niches, such as condo-buyers, seniors, etc. However, listings are currently thin in her market. To keep the websites from looking skimpy, she decides to keep several sold or expired listings on her site. This could be an example of
   A. bait and switch.
   B. collusion.
   C. commingling.
   D. negligence.

7. Antitrust laws are in place to ensure that
   A. all monies in financial transactions are accounted for.
   B. competition in the marketplace is fair and unrestrained.
   C. licensees have a minimum level of education and training to protect the public.
   D. no one is discriminated against because of race, sex, or national origin.
8. H and J run brokerages on opposite sides of town. They decide they can save a lot of money on gas if they concentrate on their side of town only. H agrees to reject customers interested in north side properties if J rejects any customers interested in south side properties. This is an example of
   A. territory allocation.
   B. blockbusting.
   C. price-fixing.
   D. redlining.

9. Which of these phrases is LEAST LIKELY to be evidence of a licensee's conspiracy to commit an antitrust violation?
   A. “If you list with us, just be aware that we will use only YES Title for the closing.”
   B. “Let's do something about Top's discount fee policy.”
   C. “Our brokerage charges 7%, but I can talk to the broker about lowering it.”
   D. “We will take the listings north of Broad Street, and they can take the ones south of Broad.”

10. G is one of three brokers recently convicted of illegal boycotting. What did he and his fellow co-conspirators do?
    A. They agreed to charge the same commission for specific services.
    B. They divided up their town into four quadrants so that each could focus on their specific area.
    C. They decided to avoid showing clients homes listed by Discount Realty.
    D. They included a clause in their listing contracts requiring clients to use AAA Co. as their home inspector.

11. At a local convention of real estate licensees, a broker mentions that he was going to have to raise his commission rate to 8% or close his office. He could be found guilty of
    A. allocation.
    B. price-fixing.
    C. securities violations.
    D. nothing; he did not violate any rules or laws.

12. S is interested in listing his house with licensee T because she is very successful. T knows that for the house to show well, the walls need to be painted and the carpet needs to be replaced. She tells S she'll take the listing as long as he uses Ultimate Remodeling to do the work. Did T do anything wrong?
    A. No, if S is okay about using Ultimate, T didn’t do anything wrong.
    B. No, she didn’t do anything wrong if she doesn’t accept a fee from Ultimate.
    C. No, she doesn’t have to accept the listing if she does not want to.
    D. Yes, T could be guilty of promoting an illegal tie-in arrangement.

13. After the weekly business meeting of XYZ Realty, two licensees decide it makes sense to be more focused in their prospecting. Licensee A decides to stay on the north side of town, and licensee B decides to stay on the south side of town. What type of antitrust violation might this situation be considered, if any?
    A. boycotting
    B. tie-in arrangement
    C. market allocation
    D. no violation

14. B is a licensed salesperson for ABC Realty in Newtown. Her mother is selling a house in Oldtown, which is 100 miles away. Mom lists the property with ABC, but because B's name is well-known in Oldtown, and ABC Realty is not, B puts up a yard sign with just her name on it. What kind of ad is this?
    A. blind
    B. spam
    C. spot
    D. tied-in

15. The Federal Trade Commission ordered Best Deal Real Estate and We Sell Homes Fast Realty to destroy a common commission tip sheet that they shared with their licensees. This is an example of
    A. actual damages.
    B. a cease and desist order.
    C. injunctive relief.
    D. punitive damages.
16. You can contact a former client for up to ______ after a transaction closes even if that client is on the National Do Not Call Registry.
   A. 3 months
   B. 9 months
   C. 12 months
   D. 18 months

17. The National Do Not Call Registry regulations require companies to update their internal customer lists every
   A. 30 days.
   B. 45 days.
   C. 3 months.
   D. 6 months.

18. Broker D sold a house to S a year ago and just heard that she's being transferred. Even though her name is on the National Do Not Call Registry, can D call her to see if she would list her house with him?
   A. No, since her name is on the national DNC Registry, she is protected from solicitation for new business.
   B. No, the transaction was so long ago that they no longer have an established business relationship.
   C. Yes, assuming that her name is not on his company's internal do not call list.
   D. Yes, they have an established business relationship that allows him to call her for up to 18 months with no restrictions.

19. ABC Real Estate Company bought an e-mail list from a vendor and sent out 5,000 e-mails soliciting business. To comply with provisions of the CAN-SPAM Act, ABC must honor any opt-out request within ______ of receiving it.
   A. 3 business days
   B. 10 business days
   C. 30 days
   D. 60 days

20. Which federal law requires companies to take measures to secure and dispose of sensitive personal information of consumers?
   A. CAN-SPAM Act
   B. Do Not Call Act
   C. FACT Act
   D. Gramm-Leach-Bliley Act
In the broadest sense, property management can be defined as leasing or renting, or offering to lease or rent, real property of others for a fee, commission, compensation, or other valuable consideration. There is a demand for properly trained and licensed professionals; therefore, many real estate licensees are choosing to make property management their specialty. This chapter provides a general look at the duties and authority of a property manager. It’s important to note that most states and municipalities have specific laws that define the rights and duties of lessors (landlords) and lessees (tenants). Make sure you are familiar with the laws in the jurisdictions where you practice.

After reading this chapter, you will be able to:

- Identify the relationship between a property manager and a property owner.
- Describe the activities that occur in various phases of the tenancy cycle.
- Recall the duties and responsibilities of landlords and tenants.

**Key Terms**

<table>
<thead>
<tr>
<th>Contract Rent</th>
<th>Implied Warranty of Habitability</th>
<th>Property Management Agreement</th>
</tr>
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<tbody>
<tr>
<td>Eviction, Actual</td>
<td>Market Rent</td>
<td>Property Management</td>
</tr>
<tr>
<td>Eviction, Constructive</td>
<td>Notice to Occupancy Standard</td>
<td>Property Manager</td>
</tr>
<tr>
<td>Eviction, Retaliatory</td>
<td>Operating Budget</td>
<td>Resident Manager</td>
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<tr>
<td>Eviction, Self-help</td>
<td>Order of Eviction</td>
<td>Security Deposit</td>
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<tr>
<td>Forcible Entry and Detainer Action</td>
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The Property Management Profession

A **property manager** is a person hired by a real property owner to administer, market, and maintain property, especially rental property. However, property management goes beyond collecting rent and leasing apartments or office buildings. A property manager is considered the **custodian and supervisor** of an owner's property.

For those wanting to specialize in a property management career, a **real estate license is a must.** Most states require anyone who takes a listing, publishes a listing, negotiates a lease, and/or interacts with potential tenants to have a real estate license. Unlicensed personnel generally may interact with tenants after a unit has been leased, for example, to collect rents, arrange for maintenance, etc., but they cannot negotiate a lease and sign it. This lease would likely be unenforceable.

Property managers need a diverse set of skills, regardless of the type of property they manage. For example, anyone choosing to specialize in the property management field must:

- Understand leasing regulations to collect rents.
- Possess basic construction knowledge to ensure routine maintenance is performed.
- Create and manage reports and budgets for property owners.
- Communicate well.
- Understand basic marketing principles.

Property Manager/Owner Relationship

Both a property manager and a property management company have an **agency relationship** with a property owner, who is the principal. As an agent, a property manager owes the property owner the same fiduciary duties of obedience, loyalty, disclosure, confidentiality, accountability, and reasonable care owed to all clients. Such an agent is a person in a position of trust, held by law to high standards of good faith and loyalty.

In this relationship, a property manager or property management company is a **general agent** because of the broad range of duties performed. A general agent is an agent authorized to handle a wide variety of the principal’s affairs in one area or in specified areas.

A key to becoming a successful property manager is the ability to understand and fulfill the goals and objectives of the owner. An effective property manager is a true asset who must:

- Maintain or increase the property’s value.
- Create income and manage expenditures for the owners.
- Reduce the property owner’s risk.

A property manager must also develop and maintain a plan for the maintenance and rehabilitation of the building so that it produces the **greatest amount of rental income** for as long as possible.
The Property Management Agreement

A property management agreement, also called a property management employee contract, is a written agreement that creates an agency relationship between the property owner/investor and the property manager. This agreement details the duties, responsibilities, allocation of costs, and compensation of the property manager. A management agreement should be signed by both parties.

A critical component of a property management agreement is the detailed description of the property manager's authority related to tasks, such as the following:

- Selecting tenants
- Signing leases
- Setting and collecting rents
- Handling security deposits
- Initiating eviction procedures as necessary
- Hiring staff and outside vendors

Any limitations to the property manager's authority must also be indicated in the management agreement. For example, some owners limit the property manager's authority for signing leases to a specific time frame or amount.

An owner's responsibilities vary and should also be listed in the management agreement. This could include information on who oversees payroll and insurance, as well as providing direction on any monthly, quarterly, and yearly payments.

Regardless of how involved a property owner chooses to be, the owner should be responsible for providing all documentation, records, and disclosures as required by the management company/property manager to manage and operate the property.

Components of the Property Management Agreement

A property management agreement should contain the following elements:

- **Description of the Property.** An exact address must be part of the agreement and sometimes a full legal description is necessary. It is also important to define the perimeters of the property, including any ancillary buildings, structures, or other amenities. For example, is the landscaping out front or the gift shop in the lobby included in the management responsibilities? If not, those exclusions need to be written into the contract.

- **Term of Agreement.** The term of the agreement varies from property to property and from owner to owner and is negotiated between the property manager and owner. One year is a common term. If the owner and property manager are satisfied with the relationship after one year, a longer term can be negotiated, and the contract can be renewed. It's important to note that some states require property management agreements to provide a definitive expiration date. Failure to include such a provision in the agreement could result in the loss of license.

- **Management Fee.** Since so many factors can affect the profitability of a property, there is not a single way to compute management fees. Property managers should determine both the direct and indirect costs associated with their job. They can use this information to arrive at an agreement with the property owner on the management fee they charge. Management fees may be fixed (flat) or a percentage.
A flat fee is a specific fee paid at specific increments. A percentage fee is based on the operation's gross collectible income. The percentage fee could also be a fixed percentage of rent or a bonus when a certain number of leases are signed.

- **Habitability and Repairs Policy.** The management agreement should provide guidelines for how the management company/property manager handles repairs. Some property management agreements, for example, state that property managers must get owner approval for repairs costing over a certain set dollar amount. But when a property manager feels that a repair is necessary for the habitability of the building and the owner refuses to approve it, the property manager should have the right to terminate the agreement immediately.

- **Accounting Responsibilities and Reports.** Accounting for all income and expenditures is more involved than it sounds. Property managers are responsible for setting rents that cover all expenses associated with operating the building and return a profit. Property managers prepare property management reports to inform owners of the status of the property, often including income, expenses, and disbursement information. The management agreement should clearly explain when the report must be distributed and to whom.

- **Management Agreement Termination.** Details about the termination of the owner-manager relationship should be spelled out in the management agreement. In case an owner wishes to cancel an agreement early, information about the property manager's compensation for negotiated leases and contracts not yet executed should be stated.

### Property Management Organizations

A property manager could have different roles, depending on the extent of the owner's property, for example:

- **Property Manager.** Oversees the management of multiple properties for various owners.
- **Building Manager.** Manages just one building.
- **Resident Manager.** Represents a property management firm and may live on the premises of the building that he manages.

A property management organization may be a single licensee or a vast corporation. A property management company can focus completely on the tasks of managing properties for its owner clients; it might be a few people or a huge enterprise with dozens, if not hundreds, of employees. Many property managers work in a property management division within a commercial real estate brokerage. There is a beneficial synergy between sales agents and property managers because the brokerage can provide the property management for their clients and, at some time in the future, even have the potential of more sales.

### Solo Property Managers

A real estate licensee who is interested in being her own boss and controlling as much of the business as possible might choose to become a solo property manager for one or more property owners. An obvious challenge is that the solo property manager is responsible for every task. Success in such a situation can be quite time-consuming. Even if expansion is desired, solo property managers may discover that it is hard to find time to work on the business, since approximately 95% of their time is spent working in the business of managing properties.
Property Management Designations

Various associations and groups offer specialized designations and accreditations in the field of property management that increase the knowledge, skill base, and marketability of licensed professionals:

- **Building Owners and Managers Association International (BOMA)** offers professional development courses for property managers, including Real Property Administrator (RPA).

- **Institute of Real Estate Management (IREM)**, a National Association of REALTORS’ (NAR) affiliate group, provides education and designations in the property management field, including Accredited Residential Manager (ARM) for those specializing in residential property management and Certified Property Manager (CPM) for those who meet certain other requirements.

- **National Association of Residential Property Managers (NARPM)** offers designations including Professional Property Manager (PPM) and Master Property Manager (MPM).

Duties of a Property Manager

Property management work goes well beyond finding good tenants. Property managers are responsible for the buildings and the budget, too, which requires them to understand maintenance, insurance, security, and operating expenses.

Property Maintenance

Property managers should have a general knowledge of major building systems and components, such as electrical, structural, waterproofing, plumbing, HVAC, gas, security, and elevators. Having a basic understanding of these systems or components enables property managers to effectively plan for preventive maintenance and work with maintenance staff, as well as talk with contractors and builders.

Maintenance costs should be carefully scheduled and controlled because they represent a relatively large part of a property’s operating budget. A property manager’s maintenance responsibilities can generally be divided into three broad categories:

- **Preventive Maintenance.** Includes routine maintenance to keep equipment and the property in good working order. This could include scheduled inspections and the replacement of parts before they fail.

- **Corrective Maintenance.** Restores broken or failed equipment to a specified condition. Repair work may be a less frequent expense, but property managers need to line up qualified repair people they can call at a moment’s notice.

- **Cosmetic Maintenance.** Increases a property’s appeal. Adding new wallpaper to a lobby or planting flowers next to a walkway can attract new tenants.

Insurance and Risk Management

Risk management is the process of identifying, managing, and minimizing the potential risks on a property. To protect owners from major expenses, property managers need to make certain they have blanketed the property with appropriate insurance sufficient to cover the greatest risks, purchased at the most economical rates.
Insurance policies can protect against such risks as:

- Damage from fire, flood, wind, and other acts of nature
- Workers’ Compensation claims
- Liability for contractors, etc.
- Loss of income and loss of occupancy
- Equipment and machinery
- Vehicles owned by and used for the property
- Injury liability

Other General Responsibilities

Property managers are generally required to keep the premises secure for the enjoyment of the tenants, keep it clean and free of garbage, and keep it safe. This means property managers may be required to stop noisy parties, add security features such as lights, rearrange parking areas, etc. Other responsibilities include:

- **Alterations and Special Requests.** Usually, tenants who request special alterations to their space, like adding or removing walls, special wiring, etc., need to obtain permission and pay for their alterations themselves. Of course, special alterations can also be a negotiating point between property owners and potential tenants. If the only way to fill non-leased space is by modifying it, the property owner may elect to do so rather than let it sit empty.

- **Appraisal.** An appraisal is an opinion of the value of property, as of a specific date, supported by objective data. When a building is appraised, the property manager is the one who interacts with the appraiser. Therefore, it is important to at least have an understanding of the appraisal process. The condition in which the property is kept and the maintenance of building systems can have a large impact on a property’s value.

- **Ecology.** There has been a national movement toward running homes and businesses in environmentally friendly ways. In fact, some buildings are specifically designed to be energy efficient and less taxing on the environment. Depending on the market and the specific property, it is important for property managers to be aware of ways they can save energy and/or money on electric, gas, water, and landscaping.

- **Purchasing.** No matter how big or small a property is, or how many people there are to manage, all property managers should have an understanding of purchasing. It is not unusual for property managers to be responsible for purchasing supplies, writing purchase orders, and paying a wide variety of contractors. Many larger companies have purchasing departments that can assist the property manager in these duties.

- **Union Negotiations.** Some property managers need to have an understanding of union contractors. Maintenance staff, or other building service staff, may be part of unionized labor, which has different needs and schedules than non-union labor staff.

Management Proposal

Property managers must have some knowledge of appraisal, finance, money markets, depreciation techniques, financial trends, and local market conditions to produce useful reports that allow them to communicate the condition and financial status of the property to the owner.
After the owner’s objectives are understood and a management agreement is signed, developing a well-thought-out management proposal is the next step. A management proposal is the plan created by the property manager for overseeing the property. The management proposal should lay out an effective strategy for meeting the owner’s financial and operational goals. A management proposal generally includes the following:

- One-year operating budget or income statement
- Five-year plan or stabilized budget
- Market analysis of the region, neighborhood, and property, which allows property managers to gain an understanding of the economic factors, population, zoning regulations, transportation, and other forces pertinent to the managed building’s location

### Income Statement

An income statement is created to project the income and expenses for the property over a one-year period. This report usually includes the projected income from rents and other sources, such as parking or vending. Additionally, it is a generally accepted accounting practice that some vacancy losses are expected to be shown in the operating budget, even if they are minor, because no property is expected to always be 100% occupied.

A critical element of an income statement is the projection of expenses. Obviously, there are many costs associated with owning, operating, and maintaining property. Expenses can be categorized broadly as fixed, variable, and capital:

- **Fixed expenses** are ongoing operating expenses that do not vary based on occupancy levels of the property (e.g., property taxes and insurance).
- **Variable expenses** are operating expenses necessary to the property, but dependent on the property’s occupancy level (e.g., repairs and maintenance, income taxes, salaries, and utilities). Potentially large expense items are the total amount of annual maintenance and repair costs. Property management expenses are included in this category, even if the owner manages the property himself.
- **Capital expenses**, also referred to as reserves for replacement, are used to improve the property and increase its value. Sometimes they are planned, but other times they are needed immediately to replace something on the property that is no longer working, such as a roof or an air conditioning unit. These expenses are different from regular maintenance expenses. Capital expenses are generally for long-term investment components. Some large capital expenses, such as those for property renovations, may be amortized over several years, but they are reflected in the annual operating budget.

The operating budget does NOT include debt service.

### Other Financial Reports and Statements

To develop a one-year operating budget for the management proposal, and to meet their fiduciary duty of accounting, property managers develop a variety of financial reports that allow them to communicate the condition and financial status of the property to the owner.
After creating an income statement with fixed and variable expenses, property managers should develop a **stabilized budget**, which is the income and expenses averaged over a five-year period. This long-term forecast takes a variety of factors into consideration, such as potential growth, market trends, etc.

While an income statement shows income and expenses associated with a property over period of time, a **balance sheet** provides a snapshot of a specific property at a specific point in time. A balance sheet may include details such as:

- The total amount of cash in the account
- The total liabilities in terms of security deposits, etc.
- The amount of equity the owner have in the property
- The current loan balance on the mortgage

After all property management reports have been generated, the property manager should be able to develop the management proposal and include **recommendations** to the owner about the property.

**Leasing Property**

When a property owner and a property manager agree with the terms of a management proposal, the property manager’s mission then becomes the execution of that plan. **Leasing space** is a critical responsibility of a property manager. The steps in the **tenancy cycle** are the same with every rentable unit. A well-prepared and organized property manager can help ensure that empty units are rented quickly and then provide a continuing income stream for the property owner.

![Figure 21.1 The Tenancy Cycle](image-url)
Preparing to Lease

When a unit becomes vacant, any delay in preparing for a rental is costly—every day delayed is a day’s rent that can never be recovered. The lost income from waiting two weeks for a crew to remove junk left in a unit, touch up the painting, and clean the carpet could exceed the cost of preparing the unit for rental. It might have been better to pay a premium to people who would get in immediately when a unit becomes vacant and finish the work in a few days.

When there are several identical-unit vacancies, property managers may prepare one as a sample unit. It might even be decorator furnished. However, property managers must ensure that all units will be prepared for rental in an identical manner, or there may be some unhappy, short-term tenants.

Rent

Rent is the consideration a tenant gives a landlord in exchange for temporary possession of the property. A property owner may not be the best person to analyze the market and determine what the appropriate rent should be, especially if the owner does not personally live in the area where the property is located. When the property is in a tough market, it may be a significant challenge for the owner to understand how difficult it is to find tenants for the property. When considering rent, note the difference between the following terms:

- **Contract rent** (sometimes referred to as current rent) is what tenants are actually paying in rent, as stated in the terms of the lease and maintained on the rent roll.
- **Market rent** (also referred to as economic rent) is what the property could rent for in the open market if currently vacant and available.

Setting Rent

A property manager is always challenged to charge market-appropriate rents while maintaining an acceptable occupancy level. For example, if the occupancy level is consistently 95%, the rent might be too low. Some property managers never adjust the rent for an income-producing property, or they opt to apply a rent adjustment only for a new tenant at the time of the initial lease or renewal. Others may be quite knowledgeable of the rental market and maintain their leases with provisions for rent to reflect the current market.

A property manager should evaluate factors such as location, amenities, condition of the property, square footage, vacancy rates, etc., to determine fair market rent. A critical factor to consider as well is supply and demand. When there’s an overabundance of rental units available, it may be necessary to lower the rent to entice tenants.

Ultimately, a property manager has a fiduciary duty to the property owner to ensure that the rent is sufficient to meet the operating expenses of the property and provide the property owner with the expected return.
**Rent Control**

As with any contract, the landlord and tenant are generally free to negotiate the terms of their lease. There are, however, some special limits on freedom of contract with residential leases. Housing shortages often put residential landlords in a much stronger bargaining position than their tenants. Furthermore, residential landlords tend to be more sophisticated than tenants, with a much better understanding of the legal effects of lease provisions.

Some states and individual communities have rent regulation programs known as rent control or rent stabilization. Rent regulations are intended to protect tenants in privately owned buildings from illegal rent increases while allowing property owners to earn enough from rent to properly maintain their buildings and recognize a profit. Typical rent control laws restrict the amount of rent charged by property owners and restrict the right of an owner to evict tenants. Rent control regulations may also offer additional tenant protections, for example, the right to have their leases renewed.

**Finding Tenants**

A strong marketing campaign helps property managers reach a pool of preferred tenants and can help to convince prospects to sign leases. By deciding whom they need to reach and the best ways to reach them, managers can build an effective campaign. First, property managers should do what they can, within the budget, to make the property more attractive. Then, they need to assess the supply and demand in the area and decide, based on prevailing conditions, how much of a marketing effort is needed. For example, if there is a high vacancy rate, they will need a more aggressive marketing campaign than if there is a single vacancy in a high-demand market. In addition to various media outlets, current tenants are an excellent source for referrals. Depending on state law, property managers may be able to offer a bonus, such as a one-month reduction in rent, for good referrals.

Filling a vacancy is a priority; filling it with the right tenant is a higher priority. It is just not worth renting to a bad tenant because it is quicker.

**Fair Housing**

It’s important to note that real estate licensees are not obligated to respond to every question that a prospective tenant asks. Suppose a prospective tenant who asks, “What types of families live in this building?” Questions about the ethnic or racial makeup of a neighborhood or building, even when answered in good faith with no intention to discriminate or encourage discrimination, are particularly tricky. Anything beyond a very simple, factual answer could be considered discrimination.

It’s safest to avoid any discussion of race or ethnic background, and so an easy and appropriate response may simply be, “Legally, I cannot answer that.”

The federal Fair Housing Act, you’ll recall, prohibits discrimination in the sale or lease of residential property based on the protected classes of race, color, religion, sex, handicap or disability, familial status, and national origin. The specific jurisdictions in which you practice may have additional protected classes.
Lease Application

A standard lease application helps ensure that every applicant is treated equally and fairly. The detailed information contained in a lease application gives a landlord or property manager an objective basis on which to evaluate every potential tenant. A typical residential lease application would ask the applicant and any co-applicant to provide the following information:

- Full legal name (and any other names the applicant may use or be known as)
- Names of all anticipated occupants
- Contact information
- Driver’s license number (or some other government-issued ID number)
- Social Security number
- Date of birth
- Dependents and their ages
- Pets
- Employment information, including employer name and contact information, job title, status, years at the job, salary/hourly pay
- Details about previous residence(s), including location, rent, reason for leaving, and contact information
- Credit history, including banks
- Personal references
- Other sources of income that the applicant wishes to disclose

Equal Credit Opportunity Act

The federal Equal Credit Opportunity Act (ECOA) prohibits discriminating against someone based on the source of his income, among other things. This applies to leasing residential property as well. For example, the income that someone receives from regular and continuing public assistance should be considered equal to any other stable income. While the ECOA clearly indicates that reliable alimony, child support, or separate maintenance payments should also be considered as income, an applicant is not required to disclose such income. Applicants cannot be discriminated against for exercising their good faith rights of nondisclosure of those sources of income. Applicants can, however, be disqualified based on their ability to pay and their credit standing.

Even if a property manager determines that the prospective tenant would not qualify for a unit, he should never refuse an application.

Investigation

Most rental applications require a signature authorizing the lessor or property manager to investigate applicant information, such as credit history, criminal history, and rental history. Applicants may be asked to provide a non-refundable fee to cover the costs of this background check.

Although a property manager cannot refuse to rent to applicants based on their membership in a protected class, as defined by fair housing and credit laws, there certainly are legitimate reasons to reject an applicant, for example, if the applicant:

- Has been evicted or has a history of not paying rent on time.
- Does not have a reasonable level of income to support the rent payment and other living expenses.
- Has a previous bankruptcy or a history of not paying bills.
- Has been convicted of a crime, such as selling or manufacturing illegal drugs.
The Department of Housing and Urban Development issued a guidance in 2016 indicating that refusing to lease to someone because of their criminal record could be a form of illegal discrimination, citing the disparate impact of the criminal justice system on minorities.

**Occupancy Standards**

While landlords and property managers cannot place limits on tenants based on their membership in a protected class, they may limit occupancy if the number of people in a rental unit violates local occupancy and health laws. An occupancy standard establishes the maximum number of occupants allowable in a given rental unit. It is intended to help promote an adequate and safely occupied inventory of housing. Great care should be taken when setting an occupancy standard so as to not infringe on any fair housing laws.

To establish an occupancy standard, a property manager should research the local housing, building, zoning, and fire codes. The licensee should also determine if the dwelling has any physical configuration or utility service limitations that might affect a reasonable occupancy standard. Based on the information gathered, the licensee would prepare a written statement indicating the maximum number of occupants that the dwelling can reasonably accommodate. Each dwelling under ownership or management should be reviewed in this manner.

If the occupancy standard reasonably makes available housing to households with children, then the licensee who established it has more than likely abided with the intent of the familial status provisions of federal, state, and local fair housing laws. Occupancy standards must not restrict the number of children, their ages, or the makeup of the family members in a dwelling, and standards should have no differences in terms or rates established for other various household configurations.

The reasonableness of all occupancy standards is considered by the U.S. Department of Housing and Urban Development (HUD) on a case-by-case basis.

**Security Deposits**

To ensure compliance with the lease provisions, most landlords require tenants to pay a security deposit before the tenancy begins. If the tenant pays the rent in full and keeps the property in good condition, the property manager should return the whole security deposit when the lease ends and the tenant vacates. If the tenant has breached the terms of the lease or failed to look after the property, the landlord may be able to keep part or all of the deposit to cover damages.

Most states have laws that govern the collection and disbursement of security deposit funds, including the requirement to maintain such funds in an escrow account separate from day-to-day operational funds.

A security deposit is not supposed to be used to repair ordinary wear and tear, however, or to put the property into better shape than when the tenant moved in.
Generally, a landlord may use the security deposit only as reimbursement for:
- Actual damages to a rental unit or shared facility that go beyond normal wear and tear.
- All rent that may be in arrears according to the lease.
- Any rent due when a tenant prematurely terminates a lease.
- Any of the tenant’s unpaid utility bills.

While a landlord typically cannot use a security deposit for cleaning the rental unit, a landlord could impose a separate nonrefundable cleaning fee or pet fee when negotiating the lease.

### Inventory Checklists

To document any damage that could affect how much of the tenant’s security deposit may be returned, residential landlords generally give two copies of an inventory checklist to a new tenant. The checklist documents the condition of all items in the unit that are owned by the landlord, such as carpet, draperies, appliances, shelves, paint, doors, furniture, plumbing fixtures, etc.

When the tenant moves in, she should complete the commencement checklist, noting the condition of the listed property, and return one copy of the list to the landlord. Some landlords even take photos of furnished units prior to renting and have the tenants sign and date each photo. This is helpful should there be a dispute later about damage to the units.

When tenants move out of their leased residential property, the property manager or landlord will generally use her copy of the tenant’s commencement inventory checklist to complete a termination inventory checklist. The property manager walks through the property with the list in hand, indicating any damages or missing items that may be attributed to the tenant. The property manager then determines an estimate for any repairs and define the amount, if any, she intends to withhold from the balance of the security deposit.

### Service and Support Animals

The Americans with Disabilities Act has a very specific definition of a service animal: Any dog or miniature horse that is individually trained to do work or perform tasks for the benefit of an individual with a disability. The tasks must be directly related to the person’s disability. For example, a person with diabetes may have a dog that is trained to alert him when his blood sugar reaches high or low levels. Or, a person who has epilepsy may have a dog that is trained to detect the onset of a seizure, and then help her remain safe during the seizure.

Under the provisions of the ADA, employers, public entities (including public housing), and public accommodations must make reasonable accommodations for policies, practices, and procedures to accommodate persons with disabilities. This includes the requirement that public entities that have a “no pet” policy waive such a policy for disabled residents who require a service animal. Furthermore, the owner cannot charge an additional deposit or increased rent for a resident with a service animal.

The definition of emotional support or companion animals is much broader. Generally speaking, an emotional support animal provides emotional or physical support, lessening the effects of a person’s disability, such as anxiety disorders, post-traumatic stress, depression, bipolar disorder, and other impairments recognized by the federal Fair Housing Act.
An emotional support animal does not have to be specifically trained to perform a task, however, and there are no restrictions on the species of a breed of animal that could be considered as an emotional support animal.

Persons claiming a disability can request a reasonable accommodation that would allow them to keep an emotional support animal if it’s necessary for them to fully enjoy and use the dwelling. The landlord or property owner must comply as long as the request doesn’t create an undue financial or administrative burden or fundamentally change the nature of a building. However, landlords may be allowed to require documentation proving the disability and the need for the emotional support animal.

Relationships With Tenants

Property managers who maintain good relationships with tenants tend to have fewer problems and lower turnover.

The original legal basis for a tenant’s right to privacy is something the courts call “the implied covenant of quiet enjoyment.” Under common law, this implied covenant is considered part of every lease, unless agreed otherwise. It provides that the tenant has a right to undisturbed possession of the property during the lease term. The tenant is protected from intrusion by the landlord or by anyone else claiming a right to the property.

To exercise the right of entry, a residential landlord must follow the laws in the jurisdiction where the property is located. For example, except in an emergency, the landlord may enter the property only at reasonable times and only with permission from the tenant. The landlord or property manager is able to enter in the event of an emergency, such as a water leak or a fire.

A Tenant’s Duties

The tenant’s primary duty is to pay the rent as agreed. Most leases state a specific date when rent is due, usually at the beginning of the rental period. Tenants also bear some responsibility for maintenance, repairs, and the habitability of leased property. Tenants must not intentionally or negligently damage any part of the property or permit guests to damage it. Furthermore, a tenant is expected to:

- Keep the rental unit safe and sanitary.
- Dispose of rubbish and garbage.
- Keep the plumbing fixtures clean.
- Use all electrical and plumbing fixtures properly.
- Comply with health and safety codes.

A tenant isn’t liable for the ordinary wear and tear that results from normal use of the property, although a tenant may be responsible for keeping the appliances in working order if the lease specifically gives the tenant that duty.
Hoardings can be defined as the collection of and failure to discard a large number of possessions that appear to be useless or of limited value and that interfere with daily functions. Often, hoarders maintain living spaces that are so cluttered that it results in safety or health hazards. Studies show that most people who are classified as hoarders suffer from one or more mental health disorders, such as depression, anxiety, or obsessive-compulsive disorder. While not specifically recognized under the provisions of the ADA, some states consider hoarding to be a mental impairment that qualifies as a disability. If a landlord knows, or should know, that a resident is a hoarder, reasonable accommodations should be made to assist the person and avoid eviction.

A Landlord’s Duties

Generally speaking, a residential landlord is expected to:

- Comply with all building, housing, health, and safety code provisions that materially affect health and safety.
- Make all repairs and do whatever is necessary to put and keep the property in a fit and habitable condition.
- Keep the common areas safe and sanitary.
- Maintain the electrical, plumbing, sanitation, heating, ventilation, and air conditioning equipment in good and safe working order.
- Supply running water, hot water, and heat.

These duties are referred to as the implied warranty of habitability, also known as the covenant of habitability. By offering residential property for rent, the landlord implicitly guarantees to the tenant that it’s fit for human habitation. Disclaimers in the lease can’t change that.

Eviction

If a tenant breaches the lease contract, an owner can choose to terminate the contract by evicting the tenant. Eviction is the forced removal, by legal means, of a tenant and the tenant’s belongings from a leased premise. The key word in this definition is legal. This process is known as actual eviction. In most states, a landlord has a legal right to go to court and start the eviction process against a residential tenant if the tenant:

- Has not paid the rent.
- Causes extensive and continued physical damage to the property.
- Engages in activity that results in a serious and continuing health hazard.
- Engages in illegal drug activity or other criminal offense on the property.
- Violates a provision of the lease that allows for termination.
- Remains in the property after the lease has naturally expired.
Actual Eviction Process

While the steps to achieve legal eviction are determined by state statute, the process to evict a tenant who has breached a condition of the lease is generally comprised of three basic steps:

<table>
<thead>
<tr>
<th>STEP 1: Notice to Quit</th>
<th>STEP 2: Forcible Entry and Detainer Action</th>
<th>STEP 3: Order of Eviction</th>
</tr>
</thead>
<tbody>
<tr>
<td>A notice to quit (sometimes referred to as a notice to vacate) is a notice to a tenant demanding that he vacate the leased property. The notice generally indicates a timeframe during which the tenant must either remedy the breach or vacate the premises. It also explains the legal action the landlord may take to regain possession.</td>
<td>The landlord may file a forcible entry and detainer action in the applicable court if a tenant does not remedy the breach or vacate the property. This is a lawsuit filed by a landlord to regain possession of the property. This legal proceeding uses the word “detainer” because the tenant is “detaining” the property without right and against the landlord’s wishes.</td>
<td>If the court finds the landlord is entitled to possession, it issues an order of eviction, sometimes called a writ of execution, directing a public officer (often the sheriff or marshal) to seize the property to regain possession for the owner. If the tenant does not vacate as directed, the sheriff can forcibly remove the tenant and his belongings from the property.</td>
</tr>
</tbody>
</table>

Constructive Eviction

Tenants often raise a landlord’s breach of duty to maintain the property as a counterclaim in an eviction suit. While landlords often evict tenants because they haven’t paid the rent, a tenant might claim he wasn’t paying rent because the property became unsafe or uninhabitable or could no longer be used as intended. That counterclaim does not necessarily prevent the eviction, however. By not paying the rent, the tenant has breached the lease, and the landlord has the right to evict him.

Depending on the condition of the property, a court could rule that the tenant owes the landlord less than the full amount of the agreed rent. Or, the court could decide that the situation is an example of constructive eviction, which occurs when a tenant is prevented from the quiet enjoyment of the property, for example, inoperable plumbing or lack of heat due to the owner’s negligence. To claim constructive eviction, a tenant must vacate the premises while the conditions that make the property uninhabitable still exist. Constructive eviction claims are not automatic and may require litigation.

Other Forms of Eviction

Landlords can certainly become frustrated with bad tenants, but they must resist the temptation to take matters into their own hands. There are other scenarios in which a form of eviction is used as a remedy for landlord-tenant disputes, although both are illegal in most states:

- **Self-Help Eviction.** Sometimes called a lock-out or a freeze-out, this occurs when a landlord uses physical force or other means to get rid of a tenant instead of going through the legal process. Although some commercial leases may allow a form of this, a residential landlord is generally not allowed to force tenants off the property by any means other than the legal process.

- **Retaliatory Eviction.** This occurs when a landlord evicts a tenant in retaliation for complaining about the condition of the property, code violations, violations of state landlord/tenant laws, or for participating in a tenants’ rights group. Retaliatory eviction is generally illegal in residential tenancies. Landlords are also generally prohibited from raising the rent or reducing services in retaliation for the tenant’s actions.
Challenge Activity

Match the term to the definition.

A. Actual Eviction  
B. Capital  
C. Constructive Eviction  
D. Forcible Entry and Detainer Action  
E. General Agent  
F. Implied Warranty of Habitability  
G. Market  
H. Order of Eviction  
I. Security Deposit  
J. Self-help Eviction

___ 1. The legal process of forcing someone off property or preventing someone from re-entering property.
___ 2. A guarantee that the property is safe and fit for human habitation.
___ 3. An expense incurred to improve property.
___ 4. Directs a public officer to seize the property to regain possession for the owner.
___ 5. The rent a property could demand in the open market if unencumbered by any lease and available.
___ 6. Money a tenant gives a landlord at the beginning of the tenancy to ensure the tenant will comply with lease terms.
___ 7. A summary legal action to regain possession of real property.
___ 8. The use of force to remove a tenant.
___ 9. A person authorized to handle a principal’s affairs in one area or in specified areas.
___ 10. When a landlord’s act or failure to act interferes with the tenant’s quiet enjoyment of the property or makes the property unfit for its intended use.

Summary

1. **Property management** may be defined as leasing or renting, or offering to lease or rent, real property of others for a fee, commission, compensation, or other valuable consideration pursuant to a property management employment contract. A **property manager** is a person hired by a real property owner to administer, market, and maintain property—especially rental property. However, property management goes beyond collecting rent and leasing apartments or office buildings. A property manager is considered the **custodian and supervisor** of an owner's property.

2. Most states require anyone who takes a listing, publishes a listing, negotiates a lease, and/or interacts with potential clients to have a real estate license. Therefore, a property manager has an **agency relationship** with a property owner, who is the client, and so owes fiduciary duties to owners as the principal. A property manager is a **general agent**, tasked with a wide range of duties and responsibilities. The relationship between the property owner/investor and the property manager is governed by a written **management agreement**.
3. A property manager's maintenance responsibilities can generally be divided into three broad categories: **Preventive** maintenance, which includes routine maintenance and inspections to keep equipment and the property in good working order; **corrective** maintenance, which restores broken or failed equipment to a specified condition; and **cosmetic** maintenance, which increases a property's appeal.

4. A **management proposal** is a plan created by the property manager for overseeing the property. It includes a one-year operating budget that identifies fixed expenses (which are unchanging regardless of occupancy) and variable expenses (which depend on occupancy), as well as **capital expenses**, also referred to as **reserves for replacement**, that are used to improve the property and increase its value.

5. **Rent** is the consideration a tenant gives a landlord in exchange for temporary possession of the property. **Contract rent** (which may sometimes be referred to as **current rent**) is what tenants actually pay in rent, as stated in the terms of the lease. **Market rent** (also referred to as **economic rent**) is what the property could rent for in the open market if currently vacant and available. A critical factor to consider is **supply and demand**.

6. An **occupancy standard** establishes the **maximum number of occupants allowable** in a given rental unit, often as a result of local zoning or building codes. It is intended to help promote an adequate and safely occupied inventory of housing but cannot be based on any discriminatory factors.

7. A landlord may require a **security deposit** before a tenancy begins to ensure compliance with all lease provisions. The landlord may keep some or all at the end of the lease term to cover costs related to **unpaid rent/utility bills** or **damages** that go beyond normal wear and tear. Many states require security deposit funds be maintained in a separate **escrow account**. **Inventory checklists** at move-in and move-out can help document the condition of the unit and support a property manager's decision about retaining part of a security deposit.

8. If a tenant **breaches the lease contract**, an owner can choose to terminate the contract by evicting her. **Actual eviction** is the forced removal, by **legal means**, of a tenant and his belongings. It typically requires three steps: 1. The landlord gives the tenant a notice to quit; 2. The landlord files a forcible detainer action in court; 3. The court issues an order of eviction. **Constructive eviction** occurs when a tenant vacates the premises due to the owner's negligence. A **self-help eviction**, sometimes called a **lock-out** or a **freeze-out**, occurs when a landlord uses physical force or other means to remove a tenant instead of going through the legal process. It is illegal in most states. **Retaliatory eviction** occurs when a landlord evicts a tenant in retaliation for complaining about the condition of the property, code violations, violations of state landlord/tenant laws, or for participating in a tenants' rights group. It, too, is illegal in most states.
Chapter Quiz

1. Who are the parties to a management agreement?
   A. landlord and property manager
   B. tenant and landlord
   C. tenant and property manager
   D. tenant, landlord, and property manager

2. In the property owner/property manager relationship, who is the principal?
   A. manager
   B. owner
   C. tenant
   D. tenant and owner

3. Of these, which is MOST LIKELY to help a landlord ensure compliance with a lease?
   A. market rents
   B. occupancy standards
   C. rent control
   D. security deposits

4. A property manager is most likely to be considered a ____________ agent.
   A. comprehensive
   B. general
   C. limited
   D. special

5. Which is MOST LIKELY a task that is outside of the scope of authority given to a property manager?
   A. authorize repair to the property
   B. initiate eviction proceedings
   C. maintain security deposits in an escrow account
   D. prepare the owner's income tax returns

6. A property manager becomes an agent of a property owner by signing a
   A. listing agreement.
   B. management agreement.
   C. power of attorney.
   D. specialized statement.

7. A property manager pays for biannual inspections of the HVAC system in the building she manages. This is an example of what type of maintenance?
   A. corrective
   B. cosmetic
   C. preventive
   D. routine

8. A property manager is looking over a rental application from a disabled man. What law prohibits her from discriminating against the applicant because the source of his income is primarily from Social Security?
   A. Americans with Disabilities Act
   B. Equal Credit Opportunity Act
   C. Fair Housing Act
   D. There is no such law.

9. A property owner informs the property manager that he cannot rent an available apartment to any minority. What fiduciary duty compels the property manager to follow his client’s direction?
   A. loyalty
   B. obedience
   C. reasonable care
   D. No duty compels a licensee to follow an illegal direction.

10. As a property manager works on the operating budget for next year, she evaluates the property and makes a note that it might be necessary to replace the furnace next year. This should be included in the budget as
    A. cosmetic maintenance.
    B. net operating expenses.
    C. reserves for replacement.
    D. risk management.

11. Of these, which is MOST LIKELY to have the greatest impact on market rent?
    A. management objectives
    B. property appraisal
    C. rent rolls
    D. supply and demand
12. A 20-unit apartment has not had a vacancy in five years. What might the property manager recommend to the owner?
   A. enhance the apartments
   B. raise the rent
   C. reduce the rent
   D. make no changes

13. When creating an operating budget, a property manager will include property taxes and insurance in what category?
   A. capital expenses
   B. fixed expenses
   C. net expenses
   D. variable expenses

14. The occupancy standard established for a large apartment complex indicates that two residents per bedroom is reasonable for the space. The property manager could refuse to rent a two-bedroom apartment to
   A. D, his partner J, and their adopted son and daughter.
   B. L, her daughter K, and K's two children.
   C. M, her mother A, her sister R, and R's twin infants.
   D. S, a single mother with three children.

15. A property manager likely CANNOT initiate an eviction proceeding if the tenant
   A. brings a cat into a property that prohibits non-service animals.
   B. files a complaint against the property owner with the city.
   C. refuses to take out the garbage, resulting in a rat infestation.
   D. is two months behind in paying rent.

16. A tenant is behind in her rent, yet again, and the landlord has had enough. What is the landlord’s BEST option for dealing with this tenant?
   A. change the locks to keep her out of the apartment
   B. cut off electricity to the apartment so she will leave
   C. file a complaint with the county court
   D. give the tenant a notice to quit

17. A tenant complains about everything. The landlord has to listen to his rants at least twice a week. When the tenant involves the city building inspectors, the landlord decides that she can’t wait until the lease is up and begins eviction proceedings. This is an example of
   A. actual eviction.
   B. constructive eviction.
   C. retaliatory eviction.
   D. self-help eviction.

18. The implied covenant of quiet enjoyment in a lease
   A. allows landlords to set limits on loud noises in the building.
   B. is a promise that tenants will call landlords after business hours only in the event of an emergency.
   C. requires tenants to get permission from neighboring tenants to play music after a certain time.
   D. restricts the landlord’s right of entry to the property.

19. Landlord P has had enough with her tenant D. His rent check has bounced twice in the past six months. His neighbors have complained that he parks in their designated spots, and he leaves trash in the common hallway. P shuts off his electricity and water and posts an eviction notice on his door. This is an example of
   A. actual eviction.
   B. constructive eviction.
   C. retaliatory eviction.
   D. self-help eviction.

20. A forcible detainer or unlawful detainer action is a lawsuit brought by a
   A. landlord against a tenant to evict the tenant.
   B. landlord against a tenant who removes fixtures at the end of the lease.
   C. tenant against a landlord who does not refund a security deposit.
   D. tenant against a landlord who wrongfully refuses to perform repairs.
Introduction to Commercial Real Estate

Commercial real estate can be a challenging and exciting specialty within the real estate field. What is commercial real estate? How is that different from investment real estate? For all intents and purposes, those terms refer to the same thing: Property that is used for investment purpose. As you prepare to become a licensed real estate practitioner, you may already know that you ultimately want to specialize in commercial real estate. This chapter introduces commercial real estate at a high level, looking at the marketplace and some of the pros and cons of dealing in commercial properties. We’ll discuss commercial leases and how commissions are paid on commercial real estate transactions.

After reading this chapter, you will be able to:

- Discuss the market for commercial real estate and the types of commercial properties.
- Contrast the use of various commercial leases and common clauses.
- Calculate rent based on various leasing strategies.
- Identify methods for calculating commissions on commercial transactions.

Key Terms

- Aggregate Rent
- Amenity Purchaser
- Anchor Tenant
- Base Rent
- Commercial Property
- Common Area Maintenance (CAM)
- Escalation Clause
- Graduated Lease
- Graduated Lease
- Gross Lease
- Index Lease
- Land Lease
- Load Factor
- Net Lease
- Overage Rent
- Percentage Lease
- Pro-Rata Share
- Rentable Square Feet
- Triple Net Lease
- Usable Square Feet
Commercial Property

Commercial investment real estate often brings to mind large buildings such as skyscrapers, shopping centers, or large apartment complexes with hundreds of tenants. These properties certainly do exist within the commercial market; however, most commercial investment real estate transactions are on a much smaller scale. While each type of property has its unique set of issues, one thing to keep in mind is that regardless of the type of property, the investor's goals generally remain the same: To generate an acceptable return on investment and to minimize the risk in any transaction.

Residential Property

Investors have an array of residential property from which to choose. Whether it is a single-family home in a suburban neighborhood or a multi-family apartment building in the heart of the city, residential property offers investors many advantages and disadvantages. Many real estate professionals start their commercial careers selling single-family investment properties to investors, many of whom own multiple single-family investment residences.

Single-Family Residential Properties

The market for a single-family rental property is relatively stable, and the investment could be considered more liquid than other types of commercial property. Additionally, there are usually more of these properties on the market than multi-family properties. Therefore, the market value of single-family investment property tends to be influenced by general market conditions and comparable single-family property sales, as opposed to the income the property may generate.

A challenge with investing in single-family homes, however, is generating enough rent—based on the market—to cover the costs of ownership while earning enough income to make it a viable investment. One advantage, and a reason many new investors prefer single-family homes, is the comparatively smaller management requirements. For example, renters of single-family homes may be more willing to take on tasks such as mowing the lawn, shoveling snow, etc. A disadvantage is that it is either 100% occupied or 100% vacant.

An investor purchasing a single-family property is concerned with a number of things:
- Location and school district
- Overall physical condition and maintenance requirements
- Proximity to public transportation, shopping, and services
- Rental market, rent levels, and resale potential
- Laws affecting landlords and tenants

Many of these considerations are the same as those of a potential owner who intends to live in the residence. The investor will analyze these same issues to determine the interest level of potential tenants.

Smaller Multi-Family Residential Properties

The next step up the ladder of investment properties is a small apartment building consisting of two to four units. Investors for this type of property are likely to purchase for the same reasons as investors in single-family properties, because this size and type is still relatively affordable and attractive in the marketplace, and the management requirements are smaller than with larger complexes.
There are, of course, additional considerations with a multi-family property, for example:

- Adequacy of parking
- Utility metering
- Maintenance of common areas
- Tenant privacy and compatibility
- Fire, safety, and accessibility issues
- General market conditions and rent levels

An important reason many investors are drawn to the multi-family property is that the risk of a full vacancy is somewhat diminished when compared to a single-family property. In a building with two units, if one tenant moves out, it is still 50% occupied and consequently still bringing in some cash flow rather than none.

**Large Multi-Family Residential Properties**

As the number of units in an apartment property increases, so do the management considerations and the complexity of the investment analysis. While the basic principles do not change, many additional criteria must be analyzed. Typical investors are larger companies that are adept at acquiring and managing these properties. Additional considerations involved when analyzing large multi-family properties include the following:

- Market conditions and rent levels
- Overall condition of the property
- Amenities and services available to tenants
- Adequacy of mechanical systems
- Federal, state, and local laws related to fair housing, disability, rent control, housing codes
- Adequacy of parking
- Maintenance and security of common areas
- Insurability, fire and extended coverage, liability issues

**Office Buildings**

Office buildings as investments present many opportunities because there are many types of properties used as offices, including former single-family homes converted into commercial space; small, medium, and large office buildings located in the suburbs; and downtown high rises. Selling or leasing a small suite in an office building can be the first real departure from the residential real estate practitioner's experience. This type of property can be highly specialized, and tenants often have very specific needs for this type of space, for example:

- Parking requirements
- Configuration of space
- Hours of operation and accessibility
- Ancillary services, such as on-site dining or vending, gyms, childcare
- Technology requirements, such as internet connection, satellite, etc.
- Security
Office Class Categories

In many markets, office buildings are often rated or categorized by the building’s class. Class category is usually based on a combination of building characteristics, such as these:

- Age
- Architectural design
- Location
- Building amenities and services
- Lease rates
- Occupancy
- Tenant profiles
- Building management

There are four primary classes of office buildings in most markets:

- **Class A** buildings are often new buildings in a specific market with the best design, superior construction and amenities, and features. These buildings command the highest rental rates and set the standard for the rest of the local market. Tenants tend to be image-conscious, such as law firms, corporate headquarters, etc.

- **Class B** buildings still have good location, appearance, amenities, and are still desirable. They are not quite the top of the market, primarily due to age. The type of tenant who desires Class B space includes companies that want a showplace but that may not be quite as prestigious as those that seek Class A space.

- **Class C** office buildings consist of two types: Older buildings and new buildings constructed to be highly functional. Traditional Class C buildings are generally older, still functionally viable, but not as favorably located as Class B office buildings. Some newer buildings are purposely built as Class C buildings. They are designed to yield the maximum percentage of usable office space such as for a call center or data processing. Most office buildings are Class C.

- **Class D** buildings are the balance of the older, functionally obsolete buildings needing extensive renovation. These properties are prime candidates for rehabilitation projects or teardown.

Each community has its own standards for these designations. What might be a Class A building in one market might be only a Class B building in another.

Retail Property

Retail investment property is where a specific type of market activity occurs, specifically retail sales and related business interests. Retail properties are diverse and unique when compared to all other types of commercial investment opportunities, and there is a wide range of property types, for example:

- Freestanding, single-tenant properties—large or small
- Strip mall shopping centers with smaller retail storefronts, often local businesses
- Neighborhood centers, often built around a supermarket anchor tenant, which is a magnet store strategically located to generate traffic for smaller stores
- Large regional shopping malls with multiple national anchor stores
One important factor when considering retail property is that the property owners have a vested interest in the success of the tenant who is leasing the space because rent is generally calculated based on square footage as well as a percentage of gross sales.

**Location**

First among the considerations related to retail property is the “L” word: “Location, location, location.” Both the owner (landlord) and the tenant want to know about the location and talk along the same lines when looking for a suitable property. A prime location will be a different place for different tenants depending on the type of business they own. Both the landlord and tenant will also be very interested in the following factors determining whether a specific location will meet the needs of the prospective tenant:

- Parking
- Zoning and sign ordinances
- Traffic issues, such as the number of cars that pass by the retail business, accessibility (ingress and egress), location of traffic lights, major intersections, highway on and off ramps
- Demographics, such as population, average age, income levels, education
- Appearance/market appeal
- Competition, including the proximity of similar-type businesses

**Industrial Properties**

Industrial real estate is a very broad category that includes factories, warehouses, distribution, manufacturing, and research facilities. Unlike office space, this type of property is often purchased by an investor who will use the property since it often has highly specialized features. Therefore, industrial properties must be assessed individually based upon the intended use and perhaps the overall adaptability. In addition to zoning, there are many factors to consider when evaluating industrial properties, for example:

- Site topography
- Loading docks, shipping and receiving areas
- Accessibility to transportation (highways, airports, railyards, shipping, etc.)
- Type and adequacy of mechanical systems
- Adequacy of utility service
- Environmental impact assessments, especially related to the use and disposal of hazardous materials
- Waste disposal ordinances and services

Another consideration related to industrial properties is community opposition. There may be resistance to certain types of industrial businesses that fall into the “NIMBY” category, that is, “Not in my back yard!”
Structural Considerations

When looking at industrial property, it is important to understand structural specifications, including these key definitions:

- **Floor load capacity** refers to how many pounds per square foot the floor can handle, which is important when determining whether a building can support the equipment and inventory proposed for the property.

- **Ceiling height**, also referred to as “feet under steel,” is the number of feet from the floor to the steel girders. The ceiling height determines what kind of industrial processes or equipment can be used in the space.

- **Clearspan** refers to the open distance between the inside faces of support members (columns). Some spaces may not have columns at all, which is ideal for industrial space. The amount of clearspan available will be of interest to industrial tenants who are considering the space for distribution warehouses or manufacturing processes that require wide open spaces for large machinery, assembly lines, or conveyor belt systems.

Unimproved Land

Unimproved land has special characteristics that are important to address. As with most categories of real estate, **location** is usually the first item on the list of considerations in terms of what can be done with property. Additionally, there is a long list of site considerations, including zoning and characteristics of the land itself. All of these can impact the investor’s decision whether to purchase the property.

Land listings require a professional surveyor or a surveying engineer to map the site, showing its physical boundaries and dimensions in a **survey**. The overall size of a land parcel may be recorded in square feet or acres. Recall that **frontage** is the linear measurement of the number of feet on the front or street side of the parcel. Typically, this will be toward the main road. In commercial real estate, frontage is very important, particularly for retail property, as it provides more exposure and access. If it’s a corner parcel, there will be frontage on two streets, which could be a real advantage.

When presented with the square footage of a parcel, remember that the **first number** always represents the frontage. So, a 2,000 x 1,000 square foot parcel has 2,000 linear feet of frontage.

Usable Land

The overall size of the land is not as important as what part is **usable**. Whether listing land or dealing with an investor interested in purchasing land, a physical inspection of the property will be required. Some things may be obvious on a land inspection. Other conditions may only be evident at certain times, for example, potential water problems in low elevations may appear after a storm. When dealing with land, licensees should have a thorough understanding of the features and characteristics of the site, in other words, its **topography**, which is the physical characteristics of a parcel of land including water sources, native vegetation, location of trees and rocks, soil type, and floodplains.
Licensees should be prepared to advise clients on all the zoning requirements related to a parcel of land and its permitted uses from the appropriate government body. The term “by right use” means that that proposed development for the vacant land complies with all current zoning ordinances. Alternative uses may require a variance to the current zoning. It’s also important to consider the floor area ratio (FAR), which is the total maximum size of a building permitted on a development site under zoning requirements.

Floor area ratio is typically stated as a percentage. If the maximum FAR is 25%, for example, multiply the square footage of the parcel by 0.25 to find the overall maximum building size allowed, regardless of the number of floors.

Other Considerations

There may be other considerations that will impact the development of unimproved land, such as:

- **Access/Roads.** Access to the area where the property is located. Who owns the road and who is responsible for developing and maintaining the roads that access and surround the property? Will an easement be necessary to gain access to the land?

- **Curb Cuts.** The actual access from the road to the property. Most localities require approval of any curb cuts. Engineers will look at traffic patterns to determine where the curb cut will be located.

- **Traffic Lights.** Existing or proposed traffic controls. A property that has a traffic light at its main entrance is a real plus from a commercial standpoint. Note that special assessments may be charged for traffic signs or signals, such as turn arrows, etc., that are installed.

- **Sidewalks.** Walkways typically regulated by zoning requirements. Some questions to ask include: Who will be responsible for installing sidewalks? What are the exact specifications for sidewalks in the area?

- **Utilities.** Access to water, electricity, gas, etc. If utilities are not on the property yet, how far away are they? What is the cost to the owner to bring utilities in?

- **Sanitation Services.** Access to sewers and waste removal. What type of sanitation service is required? What is the cost for waste removal from the location?

Mixed-Use Development

A mixed-use development incorporates various types of commercial property uses into one building or project. For example, a mixed-use project could combine retail and office space on the first floor with residential units on the floors above. Large development projects may also include hotels, restaurants, entertainment venues, parks, etc. This is becoming a common development strategy in many growing communities. Mixed-use properties may also combine industrial, office, and retail. The possibilities and combinations are practically endless and depend largely on local zoning laws and ordinances.
The Scope of Commercial Real Estate

Contrary to what many people assume, practicing commercial real estate in most states **does not require a special license**. In most cases, a real estate license is all-encompassing, meaning a licensee can conduct both residential and commercial real estate transactions. The basic provisions of agency law, contract law, real property law, and license law are almost identical in commercial real estate and residential real estate. What many licensees find attractive about commercial real estate is the creativity required to put transactions together. Commercial transactions are often more complicated than typical residential transactions, with greater risks and rewards. Commercial real estate investments usually require specialized knowledge and expertise different from residential transactions. Consequently, the negotiations are often more time consuming and sophisticated.

Some fair housing laws DO apply to commercial real estate. The **Civil Rights Act of 1866** prohibits racial discrimination in any property transaction in the United States—real or personal, residential or commercial, improved or unimproved.

Parties to Commercial Transactions

Every party to a commercial transaction has unique needs and motivations, but that does not mean that these parties are adversaries. Key motivations of those who engage in commercial real estate transactions may include the following:

- **Developers** of income properties carefully evaluate the risks and probabilities of success, based on their knowledge of the costs and a desired rate of return, before beginning development.
- **Buyers** carefully estimate returns on investment, using all known information, before deciding to purchase properties, whether for their own use or as a leasing opportunity. Their motivation is to realize a return on their investment.
- **Owners** and **landlords** make decisions to sell or lease based on calculations of anticipated future profit and continued risk levels before taking action.
- **Tenants** want to get the most out of their rental dollars and are concerned with the usefulness of the property for their business.

Categories of Buyers

In residential real estate, buyers will most likely occupy the property they buy, so their motivation is personal use. The property satisfies the purpose of having a place to live. In commercial real estate, there are two general categories of buyers:

- The **owner/user** who is motivated to find a location from which to house and operate a business.
- The **investor** who desires to place money where it will earn more money.

When buyers are purchasing commercial property for **their own use**, they will consider many factors depending on their needs, for example, location, size, market, competition, transportation access, etc.
When buyers are purchasing commercial property as an investment, they will use a different set of criteria, for example, the stability of the income stream, local vacancy rates, the number of competing properties, etc.

**AMENITY PURCHASERS** An amenity purchaser has a different motivation for investing in real estate, valuing a property based on its ability to fulfill his specific business needs as well as its rate of return. For example, consider the investor who has always wanted to own a vineyard. If his motive for investing in real estate was driven purely by profit, he may be smarter to put his money into warehouses or apartment buildings instead.

**Buy or Lease**

Every business owner must decide whether to buy or lease property. As a quick review:

- An owner of property has a freehold estate. Fee simple absolute is the fullest freehold interest in property. It includes all the bundle of rights (possession, quiet enjoyment, disposition, exclusion, and control). This means that a fee simple estate is inheritable and transferable.

- A lessee (or tenant) of property has a leasehold estate, which is an interest that gives the holder a temporary right to possession of the estate without having a title. An owner who leases property to a tenant is called the lessor or landlord. The landlord has a leased fee that is reversionary, which means once the tenant moves out at the end of the lease, possession reverts to the landlord.

When deciding whether to buy or to rent space from which to run a business, it's necessary to evaluate the relative merits of owning versus leasing.

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
</table>
| **Leasing** | • Flexibility of space and terms  
• Lower up-front cash requirement  
• Some tax relief (property taxes, rent, and other expenses are deductible)  
• Lower risk of obsolescence  
• Stability of costs  
• Mobility  
• Fewer management distractions  
• More capital available for expansion or inventory | • No opportunity to gain appreciation  
• Lack of control over property  
• More limited tax relief  
• Contractual penalties  
• Actual total cost often more expensive per square foot than ownership |
| **Owning**  | • Tax savings (property taxes, other expenses, and depreciation are deductible)  
• Appreciation, resulting in increasing equity  
• Income  
• Control of the property | • Initial capital outlay  
• Liability  
• Legal compliance  
• Financing  
• Management requirements  
• Inflexibility |
Alternatives to Buying or Leasing

Practically every aspect of a business operation can affect the own versus lease decision process. Business owners need to analyze the proposed acquisition to assess the relative merits of the investment. Solutions are not limited to just a straight purchase or lease, however, as commercial real estate can be very flexible.

Sale-and-Leaseback

A common financing arrangement for commercial real estate is called a “sale-and-leaseback.” In this situation, a company will construct a building that suits its needs, and then sell the building to an investor, who becomes the landlord. This allows the tenant company to have more liquid assets to invest in products or other resources, rather than having all their assets tied up in the real estate. There are also tax advantages for both the company lessee and the investor lessor.

Ground-Leases

Ground leases, also referred to as a land leases, enable tenants to lease only the land (often an unimproved parcel of land), not any structures or improvements on the land. This strategy allows tenants to make substantial improvements to the parcel of land, constructing a structure that suits the needs of the business, while the rental value reflects only a base amount for the land alone. The ground lease is very popular in commercial property development, particularly with fast food restaurants and large grocery chains.

A ground lease is typically a long-term lease, often in the form of an initial term with several options to renew. For example, an initial lease term could be 10 years with four- to five-year options. This enables the tenant to control the property for an extended period. This is extremely important because upon expiration of the ground lease, the land, and the building erected upon it, reverts to the landowner, not the lessee.

Most ground leases are in the form of a triple net lease, which means that the tenant pays the expenses associated with ownership—property tax, insurance, and maintenance—not the landlord.

Commercial Leases

A lease is a contract between a landlord and a tenant that sets forth the terms and conditions under which real property may be occupied by a tenant. Broadly speaking, commercial leases are generally categorized by the method of rent payment and what is provided in exchange for the rent, including the responsibility for common area maintenance (CAM) charges, for example:

- Cleaning
- Landscaping and maintenance
- Snow removal
- Exterior lighting
- Decorating
- Signage
- Security
- Trash removal and dumpsters
While residential leases are relatively straightforward, commercial leases can become very complex. The lease spectrum is simply the wide range of possibilities that exist for constructing rental payment arrangements and cost recovery in different types of income properties. A gross lease is at one extreme of the spectrum, and a triple net lease is at the other end. In between these extremes is a diverse set of commercial property lease arrangements that parties to the transaction may negotiate to suit individual circumstances.

**Gross Lease**

A gross lease is a straightforward exchange of rent for occupancy; it is also called a full-service lease. The tenant pays a fixed rent, while the owner or landlord pays all ownership expenses, such as property taxes, mortgage payments, repairs, janitorial services, insurance, etc., and sometimes utilities.

In a modified gross lease arrangement, tenants may be responsible for utilities, trash removal, and cleaning. The landlord still pays the taxes and obtains damage and liability insurance. The landlord also maintains heating, ventilating, and air conditioning (HVAC) systems and security for the building.

**Net Lease**

A net lease is a lease for which the tenant pays some or all of the costs of ownership, such as utilities and repair, in addition to the agreed-upon rent. With net leases, the property owner or landlord has shifted much of the risk for increased costs to the tenants, who may get a tax benefit for this business expense. A net lease means lower base rent for the tenant, but higher costs. Net leases may be categorized by the extent of the tenant’s responsibility for paying these ownership costs:

- Taxes
- Insurance
- Common area maintenance (CAM)

Regarding these costs:

- If the lease requires the tenant to pay just one of these expenses, it’s called a single net lease.
- If the tenant is required to pay any two of these expenses, it’s a net-net lease, or a double net lease.
- If the tenant is required to pay all three of these expenses, it is a triple net, or net-net-net lease (also called an absolute net lease).

**Percentage Lease**

With a percentage lease on retail space, the landlord shares in the tenant’s success and is rewarded for owning a building in a great location and attracting a mix of compatible tenants. A retail tenant pays base rent and a percentage of gross sales over and above a breakpoint. The breakpoint is the sales volume above which a retailer makes a profit. There are two ways to establish the breakpoint:

- Arbitrary Breakpoint. The landlord and tenant negotiate the breakpoint arbitrarily. For example, they agree to a set a breakpoint at $200,000 in gross sales and a percentage of 6%. For every dollar in gross sales above $200,000, therefore, the tenant owes 6% in overage or percentage rent in addition to the base rent.
- **Natural Breakpoint.** A natural breakpoint is determined by dividing the base rent by an agreed-upon overage percentage. So, for example, if the base rent is $40,000 and the negotiated overage percentage is 8%, the natural breakpoint would be $500,000 ($40,000 ÷ 0.08 = $500,000). For every dollar in gross sales above $500,000, therefore, the tenant owes 8% in overage or percentage rent in addition to the base rent.

Most retail tenants who have percentage rent arrangements calculate the amount of percentage rent due and pay it monthly, adjusting for any discrepancies at year end.

---

**Challenge Activity**

1. Oliver is interested in opening a new coffee shop and is considering space in a recently renovated building. What issues will most likely impact his decision? Select all correct responses.

   - Demographics of the area
   - Nearby competition
   - Access in and out from the street
   - Proximity to distribution channels
   - Availability of parking
   - Local zoning limitations on signage
   - Topography of the site
   - Opposition from the community

2. The owner quotes a base rent of $2,100 per month plus a 6% overage percentage. What would Oliver’s base rent for the year be?

3. What is the natural breakpoint on this lease?

4. If Oliver has $400,000 in gross sales this year, what is his total rent?

5. If Oliver has $435,000 in gross sales this year, what is his total rent?
# Lease Clauses and Considerations

In addition to being familiar with the many types of leases available, real estate licensees should be familiar with the different types of lease clauses and other terms associated with leased property. Since a lease is the result of negotiations between a landlord and a tenant, these factors may be negotiating points.

<table>
<thead>
<tr>
<th>Clause Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Use</strong></td>
<td>A <em>use clause</em> defines what type of business can be conducted by the tenant on the premises. Most office leases state the premises will be used “only for general business office purposes, and for no other use or purpose.” Retail leases often state what type of products may or may not be sold by the tenant. Tenants usually want the use clause to be as flexible as possible so they can add goods and services. Landlords usually prefer use clauses to be specific to ensure tenants do not compete with each other. If the lease does not have a use clause or does not state a specified purpose, the tenant may use the space for any <em>lawful use</em>.</td>
</tr>
<tr>
<td><strong>Attornment</strong></td>
<td>An <em>attornment clause</em> establishes tenancy with a new owner and defends current tenants against claims for rent from the former property owner. An attornment agreement also provides that, in the event of foreclosure or termination, any lease or sublease shall continue, in force, to the unexpired term of the lease, and upon the same terms and provisions.</td>
</tr>
<tr>
<td><strong>Estoppel</strong></td>
<td><em>Estoppel</em> is a legal doctrine by which a person or party is prevented from taking a position, denying a fact, or asserting a fact inconsistent with previous conduct or statements. For example, an investor who purchases rental property may ask current tenants to sign an <em>estoppel certificate</em> acknowledging their obligation to pay the agreed-upon rent according to the terms of their existing leases.</td>
</tr>
<tr>
<td><strong>Subordination</strong></td>
<td>With a <em>subordination clause</em>, the tenant agrees in advance to grant a waiver of his rights in favor of the new mortgagee. This could result in the tenant’s leasehold rights becoming secondary to the lender in the event of foreclosure of the landlord’s loan, meaning that the lender could cancel the lease and take over the building.</td>
</tr>
<tr>
<td><strong>Non-Disturbance</strong></td>
<td>With a <em>non-disturbance agreement</em>, the mortgagee agrees to honor and not disturb, or terminate, the tenancies of lessees who are current with their rent and who are complying with all provisions and obligations of their leases.</td>
</tr>
<tr>
<td><strong>Escape</strong></td>
<td>An <em>escape clause</em> in a long-term lease allows the tenant to terminate the lease before the end of the term with proper notice. For example, a retailer is successful beyond her wildest dreams and has outgrown her space. An escape clause allows her to terminate her lease with proper notice and find a more suitable property.</td>
</tr>
<tr>
<td><strong>Accordion</strong></td>
<td>Lease terms for commercial buildings are typically <strong>one to 10 years</strong> but, for some major tenants in some markets, can be as long as 40 years, with options to extend the term further. In addition to options to extend the term, tenants occasionally negotiate options to expand or contract the size of their rented space. These provisions may be referred to as <em>accordion clauses</em>.</td>
</tr>
<tr>
<td><strong>Right of First Refusal</strong></td>
<td>A <em>right of first refusal (ROFR)</em> clause, also called a right of preemption, gives the tenant the right to have the <strong>first opportunity</strong> to buy or lease property if the owner decides to put it up for sale or lease. The clause cannot be exercised until the owner gets a <em>bona fide offer</em> from a third party. The owner must then make the property available to the tenant holding the right at the <strong>same terms</strong> as the bona fide offer. This is an inheritable interest that creates a cloud on the title and should be recorded in the public record.</td>
</tr>
</tbody>
</table>
Calculating Commercial Rent

Commercial leases are typically defined by the way rent is calculated. Rental rates could be determined using various methods or combinations of rent structure as negotiated between landlord and tenant. Understanding space measurement is exceptionally important when considering commercial real estate because rent is usually calculated based on a square footage basis, especially for office space.

Rentable Square Footage

Rentable square footage (RSF) is generally considered to be the total floor area of a building. This measurement accounts for all tenant space as well as common or service areas—such the lobby, corridors, elevators, restrooms, stairwells—that are used by two or more tenants and/or third parties and that are not under the control of any one tenant. Rentable square footage is also known as gross square footage.

Rentable square footage is necessary to calculate the lease payment for many types of commercial property, such as office and warehouse space. The tenant pays for their specific space and then a prorated share of the identified common areas.

Be aware, however, that there are a number of methods for calculating rentable square footage. For example, some property owners or markets may consider the common areas used by tenants, such as lobby and restrooms, as part of the rentable square footage, but not consider space taken up by critical structural elements, such as stairwells and elevators. Another property owner may consider the entire gross square footage as rentable square footage for the purpose of rent calculations.

To help you remember that rent calculations are based on gross (rentable) square footage rather than the net (usable) square footage, think about the word “gross” as “gro$$.”

Usable Square Footage

Usable Square Footage (USF) is the amount of actual space within the perimeter of the defined space occupied by a specific tenant. For example, a building with two floors, each containing 3,750 square feet of space, may have only 5,000 total square feet of usable space. Elevators, air shafts, stairways, hallways, atriums, etc., take up the other 2,500 square feet. Usable square footage is also referred to as net square footage or sometimes carpetable square feet.

According to the Building Owners and Managers Association (BOMA), measurement of usable square footage is from the interior finish of a permanent exterior wall or the interior of an exterior window (if the window is at least 50% of the exterior wall) to the office side of corridors and to the middle of an interior partition wall between tenants. By measuring to the middle of an interior wall, the tenants on either side of the wall actually pay for the floor space on which the wall sits.
Calculating Rent

The most common way to calculate the base rental rate in a commercial lease is as a certain dollar amount per rentable square foot. This may be stated either as annual rent or monthly rent, depending on local custom.

For Example

Rental space in a particular market that has been quoted as "$15 per square foot." So, for 10,000 square feet of rentable space, a tenant would expect to pay $150,000 per year, or $12,500 in rent each month.

\[
\begin{align*}
15 \times 10,000 \text{ SF} &= 150,000 \text{ annual rent} \\
150,000 \div 12 &= 12,500 \text{ monthly rent}
\end{align*}
\]

This simple calculation, however, does not distinguish between what the tenant is paying for and what the tenant can actually use. It’s helpful, therefore, to account for the difference between rentable space and usable space when determining rent.

Load Factor

The load factor for the property, sometimes called the add-on factor or loss factor, allows prospective tenants to compare the costs of renting in different buildings by evaluating rentable vs. usable square feet. The lower the load factor, the lower the rent per rentable square foot. This is one way to calculate the load factor:

\[
\text{Rentable Square Footage} \div \text{Usable Square Footage} = \text{Load Factor}
\]
For Example

A one-story building has a total of 50,000 rentable square feet. The lobby, restrooms, and airshafts take up 2,900 square feet, leaving 47,100 square feet of usable space.

\[
\frac{50,000 \text{ RSF}}{47,100 \text{ USF}} = 1.06 \text{ Load Factor}
\]

Here, the load factor for the building is 1.06. When speaking with a prospective tenant who wants to rent 10,000 square feet of usable space in that building, multiply the usable square footage by the load factor to determine the rentable square footage on which the rent would be based, for example:

\[
10,000 \text{ USF} \times 1.06 = 10,600 \text{ RSF}
\]

The tenant’s rent would be based on 10,600 rentable square footage.

Building Efficiency

The flip side of load factor is building efficiency, which is the ratio of usable square footage to rentable square footage. So, that office building with 50,000 rentable square feet and 47,100 usable square feet has a building efficiency of 94%.

\[
\frac{\text{Usable Square Footage}}{\text{Rentable Square Footage}} = \text{Building Efficiency}
\]

For example: \[
\frac{47,100 \text{ USF}}{50,000 \text{ RSF}} = 0.94 \text{ Building Efficiency}
\]

Increasing Rent

Of course, rent typically increases when a lease is renewed or extended. However, if the lease includes an escalation clause, rent may be adjusted, or escalated, at any agreed-upon point in the lease term. Escalation clauses, also called escalators, are typically used on long-term leases to account for increases in operating expenses or to increase the base rent.

Base Year

Escalators typically kick in after the base year that is identified in the lease. The base year, often the first year of the lease, establishes the operating expenses and taxes for the property. If there is no historical data that supports specific figures for these costs, the indicated base year might not be the first year of the lease. For example, a tenant in a new development has a five-year lease. Since there is no historical data in a new development, the base year indicated in the lease might be year two, so the rent increases will begin in year three.

The years after the base year are referred to as comparison years. The base year is used as the starting point (floor) for calculating the business expense increases. By evaluating costs occurring in each comparison year with the cost of the same expenses during the base year, increases or decreases in those expenses can be calculated.

Pro-Rata Share

When there are multiple tenants in the building, each tenant is expected to pay a proportionate share, or pro-rata share, of the operating expenses for the building. For example, if a tenant occupies 10,000 square feet of a 40,000-square foot building, the tenant’s proportionate share of the operating expenses would be 25% (10,000 ÷ 40,000).
The lease must indicate the tenant’s pro-rata share of annual expenses, additional rents, and operating costs.

Each lease should clearly define the base year, operating costs, and the pro-rata share to avoid misunderstandings between tenants and landlords.

**Pass-Thru**

Many leases allow landlords to pass along *unexpected increases* in operating costs to tenants. These charges are referred to as *pass-throughs*. For example, a tenant pays a pro rata share of property taxes as established by the base year of his lease. In year two, a new school levy passes, and the taxes on the property increase. The property owner could pass the entire cost of the increased taxes on to the tenants proportionally. In theory, tenants may be subject to an unlimited number of added expenses that could be passed through by their landlords. Therefore, tenants often negotiate a lease clause that places a maximum on their expense liabilities, which is referred to as an *expense cap* or *expense ceiling*.

**Step Increases**

Another method used to adjust base rent is the negotiated contractual *step* or *bump increase*. Under this lease provision, base rent is scheduled to step up or bump up at a predetermined negotiated percentage or pre-established dollar amount (no matter what happens to actual operating expenses). This is also known as a *graduated lease*. A graduated lease could be used, for example, to help a new business owner become established. The rent may be relatively low to start, but under the terms of the lease, the base rent increases 5% every year up to a stated ceiling.

Such fixed percentage adjustments are commonly effective on each anniversary of the lease or at the beginning of each calendar year. Often, investors find that lenders are more willing to finance buildings with the income certainty of step increases, which are used to determine net income, as opposed to the fluctuations of indexed increase methods. Lenders and many owners (and even some tenants) prefer the predictability of the fixed percentage increase.

**Additional Adjustment Mechanisms**

Leases with escalation clauses linked to a readily available indicator in the marketplace are referred to as *index leases*. During times of high inflation and rapidly rising operating expenses, indexing prevents inflation from eroding the real value of tenants’ lease payments and is especially common in longer-term leases. Common indexes include:

- **Porter’s Wage Escalation Formula**. This is used in many large cities. This provision ties the rent escalation to the wages of the building’s cleaning and building maintenance personnel (called “porters”). The formula provides tenants’ rent will increase a specific amount per square foot for a specified increase in the porters’ hourly wages.

- **Consumer Price Index (CPI)**. This is the more commonly used index, especially with *office* leases. The *CPI* is an index published monthly by the United States Bureau of Labor Standards (BLS) and is considered by many to be the basic indicator of inflation.
CPI calculations exist for the U.S. as a whole and for regions, states, and even individual markets. By basing rental increases on the increase (or decrease) in the CPI, landlords and tenants can be reasonably sure the amount of rent being paid at the beginning of the lease retains its effective purchasing power no matter what happens to the value of the U.S. dollar due to inflation.

Remember that all the terms in a lease are negotiable. Just as there is a buyer’s market and seller’s market in residential real estate, there can be a property owner’s market and tenant’s market in the world of commercial leasing.

**Compensation for Commercial Transactions**

A common reason for wanting to enter the commercial arena of real estate is the expectation of much larger commissions. This may or may not be the case. Just as in the residential side of the business, the commission a licensee makes depends primarily on the size and price of the property involved in the transaction.

The commission rate paid on the sale or lease of commercial property is negotiated between the client and the broker at the time a listing agreement is made. It’s entirely up to each brokerage to set its own commission policy. There are no fixed or established commission schedules; in fact, any attempt or effort by a group of real estate practitioners to create an acceptable commission schedule would be construed as a violation of antitrust laws.

**Commercial Sales**

Licensees may calculate commissions for the sale of commercial real estate in several ways. No matter which method is preferred and used, it should always be agreed upon upfront and put in writing.

**Fixed Percentage**

In this arrangement, the agreed-upon percentage is multiplied by the actual sale price of the property to arrive at the amount of the commission.

\[
\text{Sale Price} \times \text{Commission Percentage} = \text{Commission}
\]

**Graduated Percentage**

In some higher-priced properties or large properties that may be split and marketed as several parcels, the compensation percentages may be set on a graduated scale. For example, a broker negotiated a graduated percentage commission when she listed an apartment building for sale. The commission structure was broken down as follows:

- 5% on the first $500,000
- 4% on the next $250,000
- 3% on the next $250,000
- 2% on everything above $1 million
Fixed Fee

Some commercial practitioners may work out an agreement where a **fixed dollar amount** is paid for the performance of specific real estate services. To be paid, the fee arrangement generally requires the successful completion of the transaction.

Retainer

In certain segments of the commercial market, it’s common to compensate licensees based on a **retainer** (in advance) or based on **hours worked**. In these situations, the retainer or hourly fee is usually paid even when transactions do not close. Licensees working under this type of compensation arrangement are expected and required to keep very strict and specific accounting records of the time spent and actions taken on behalf of the client. This fee arrangement could be a percentage or a fixed dollar amount.

Commercial Leases

As with all commission agreements, the commission paid for procuring leases is based on the schedule and arrangement between the participating parties. There are a number of methods for establishing leasing commissions.

Lump Sum

Lump-sum agreements require commission to be paid either at the time of execution of the lease (signing of the lease by both the landlord and the tenant) or upon the tenant taking occupancy of the leased premises, or sometimes, half of the commission for each milestone. This commission is often based on a **percentage of the total rental value** of the lease, also known as the **aggregate rent**.

**Square Footage x Rent Rate x Lease Term x Commission Rate = Commission**

**For Example**

ABC Brokerage procured a lease for 3,000 square feet of office space. The rental rate is $10 per square foot and the lease term is for three years. The landlord agrees to pay a 5% lump-sum commission to ABC. The steps to determine the commission are:

1. Find the total rental value of the lease: 3,000 x $10 = $30,000
2. Find the aggregate rent: $30,000 x 3 years = $90,000
3. Determine the commission percentage: $90,000 x 0.05 = $4,500

When a listing agreement indicates a lump-sum commission rate based on the aggregate—or total—lease amount, be aware that it’s possible to include provisions that require payment of **additional commission** to the listing broker under certain conditions, for example, if the tenant:

- Exercises an option to renew the lease.
- Exercises an option to purchase.
- Expands the space being leased.

So, for example, the tenant has a five-year lease with three five-year options. When the tenant exercises each of those options, the property owner is obligated to pay commission to the listing broker with each renewal.
Per Square Foot Fee

When commission is based on an agreed-upon dollar amount based on the square footage of leased space, it is a **per square foot fee**. This equation is very simple:

\[
\text{Square Footage} \times \text{Fee} = \text{Commission}
\]

For example, the rent is $12 per square foot, and the commission is 60 cents per square foot. If the agent negotiated the lease on an 8,000 SF office space, her commission would be $4,800 (8,000 x $0.60).

Other Fee Arrangements

Other types of fee arrangements include:

- **Flat Fees.** For agreements with a flat fee, the commission is based on a fixed dollar amount for leasing the space, regardless of the square footage. For example, a property owner offers $5,000 to any broker who secures a two-year lease for any of his retail units.

- **Procurement Fees.** These are typically paid when a licensee is working with a tenant representative and is paid a fee for finding space for the tenant. Procurement fees are often fixed fees but could be percentage-based.

Timing of Commercial Commissions

Another consideration regarding commissions in commercial transactions is the timing at which they are paid. Most often with a sales transaction, just as in the residential arena, payment occurs at closing. However, in some local markets, large commissions for leases may be paid in **installments** over the period of the lease term (either monthly or annually). Although many licensees do not prefer this arrangement, sometimes the situation, competitive environment, and market conditions dictate it. The agreement may be that commission is paid as the landlord receives each rental payment.

When the brokerage contract calls for commission paid in installments or on renewal options, it’s a good idea to require a written **assumption agreement**. If someone buys the property, the seller would assign all current leases to the new owner, and then include an assumption agreement that would require the new owner to take the property subject to the terms of the brokerage contract, obligating the new owner to pay commissions for renewals as agreed.

Again, the amount and type of commission and the payment schedule are subject to negotiation between the real estate licensee and the client. All agreements should be **in writing and signed by all parties** to be enforceable in a court of law.

Broker Lien Laws

Many states allow commercial real estate brokers to file a **lien** to recover full payment of earned commissions. Such **broker lien laws** protect the interests of real estate licensees and cut down on commission-related lawsuits.
Most state broker lien laws require a commercial broker to record some type of notice of intent with the county clerk, much like a mechanic's lien. This must be done prior to the tenant taking possession (if a lease) or the deed being transferred (if a purchase). Such notices indicate that the broker is entitled to commission according to the terms negotiated in a brokerage agreement and that if not paid according to those terms, the broker has a right to place a lien against the property. Once an actual lien has been placed, the broker could be able to foreclose on the property, forcing the sale of the property to recover the commission owed.

Of course, each state law is different, and the specific statutory requirements must be met to pursue this solution. For example, some states allow a broker to file a lien only on long-term leases, such as three years or more. Some states do not allow brokers to pursue tenants and buyers for unpaid commission, only property owners or sellers. Most state laws include a statute of limitations. Knowing the laws in the states in which you practice is critical.

Summary

1. The terms “commercial real estate” and “investment real estate” refer to the same thing: Property that is used for investment purpose. Nearly any type of property could be considered commercial property: Unimproved land, residential property, office buildings, retail, industrial, manufacturing, and mixed-use buildings.

2. Practicing commercial real estate does not require a special license. The basic provisions of agency law, contract law, real property law, license law, and civil rights and fair housing laws are almost identical in commercial real estate and residential real estate.

3. When business owners are deciding whether to buy or to rent commercial property, they must evaluate the relative merits of owning versus leasing. Advantages to owning include tax savings, appreciation, and control. Advantages to leasing include flexibility, lower costs, and less risk. An amenity purchaser is most likely an owner/user who is motivated to find a location from which to house and operate a business.

4. Commercial leases reflect a wide range of possibilities for constructing rental payment arrangements and cost recovery. A gross lease is a straightforward exchange of rent for occupancy. A net lease is a lease for which the tenant pays the agreed-upon rent and one or more of these ownership costs: Taxes, insurance, or common area maintenance (CAM). A percentage lease is a gross or net lease in which the tenant pays a fixed monthly base rent as well as a percentage of gross sales achieved by the tenant over a predetermined level of sales known as the breakpoint; most common for retail tenants.

5. Common lease clauses include: Use (defines use of the leased space), attornment (establishes tenancy with a new owner and defends current tenants against claims for rent from a former property owner), estoppel (affirms tenants' obligations to lease terms), accordion (allows tenants to increase or decrease space as needed), subordination (places the existing lease in an order junior to that of the new mortgage on leased property), and nondisturbance (protects tenants from new owners).
6. **Rentable square footage**, also called **gross** square footage, is the total floor area of a building, including shared common areas such as hallways, elevators, lobbies, etc. **Usable square footage**, also called **net** square footage or **carpetable** square footage, is the amount of actual space within the perimeter of the tenant's premises. Commercial real estate rent is calculated based on **rentable/gross** square footage. The **load factor** is a ratio of rentable space to usable space. When a tenant's rent is calculated, that load is added on to the usable space to account for the tenant's share of the common areas. The flip side of load factor is **building efficiency**, which is the ratio of usable square footage to rentable square footage.

7. Rent is often increased when a lease is renewed or extended. If a lease includes an **escalation clause**, rent may be adjusted, or escalated, during the lease term to add value to the property and/or cover increased costs of operating the building. Escalators typically kick in after the **base year** that is identified in the lease. Some leases determine the share of common expenses on a **pro-rata share**, or proportional basis of the building's total area. Many leases allow landlords to pass along unexpected increases in operating costs to tenants, referred to as **pass-throughs**. With a **graduated lease**, base rent is scheduled to step up at a predetermined negotiated percentage or dollar amount no matter what happens to actual operating expenses. An **index lease** links rent escalation to a readily available index based on changes in the marketplace, such as the Consumer Price Index (CPI) or the Porter's Wage Escalation Formula.

8. Commission on commercial transactions can be negotiated in several ways. On commercial **sales**: Fixed percentage, graduated percentage, fixed fee, or retainer/hourly fee. On commercial **leases**: Lump sum percentage of the aggregate lease amount, per square foot fee, flat fee, or procurement fee. Commission may be paid at closing or paid periodically on a long-term lease.
Chapter Quiz

1. Which statement about commercial real estate is TRUE?
   A. The Civil Rights Act of 1866 does not apply to commercial transactions.
   B. Commercial and residential real estate share the same basic provisions for contract law.
   C. Commercial transactions are usually less complicated than residential transactions.
   D. A special license is required to broker commercial real estate transactions.

2. Which is MOST LIKELY to be an example of a typical Class A tenant?
   A. check processing operation
   B. distribution center
   C. law firm
   D. software call center

3. An advantage of having an anchor tenant is that it
   A. may attract customers to smaller stores.
   B. may force smaller stores out of business.
   C. may provide common area maintenance for other tenants.
   D. will usually stand on its own.

4. Impacts of environmental concerns are most often associated with
   A. industrial property.
   B. multi-family residential property.
   C. office property.
   D. retail property.

5. Mr. K has a parcel of land that is 300 feet x 120 feet and where the floor area ratio required for the site is 20%. What is the maximum building size permitted on this site?
   A. 1,800 square feet
   B. 6,000 square feet
   C. 7,200 square feet
   D. 9,000 square feet

6. In a sale-and-leaseback arrangement, the
   A. buyer gets possession of the property.
   B. buyer receives equitable title only.
   C. seller retains possession of the property.
   D. seller retains title to the property.

7. Why do some investors prefer a single-family residential investment property?
   A. fewer competing comparable properties
   B. larger return on investment for the owner
   C. less risk of vacancy/loss
   D. smaller management requirements

8. An investor concerned with the demographics surrounding the location is MOST LIKELY considering an investment in
   A. industrial property.
   B. multi-family residential property.
   C. retail property.
   D. single-family residential property.

9. An investor concerned with the topography of a location is MOST LIKELY considering an investment in
   A. industrial property.
   B. office property.
   C. retail property.
   D. undeveloped land.

10. F rents warehouse space. In addition to the rent he pays the landlord, F pays the property taxes and insurance. He is also responsible for maintenance of the building. What type of lease does F have?
    A. graduated lease
    B. gross lease
    C. ground lease
    D. net lease
11. B sells his strip mall property to M. M asks the six current tenants to sign a(n) __________ certificate to ensure that they will pay their contractual rent to M.
   A. attornment
   B. estoppel
   C. novation
   D. preemption

12. Net square footage refers to
   A. common space.
   B. rentable space.
   C. shared space.
   D. usable space.

13. GEM Inc. is the largest of 10 tenants in a 10,000-square foot office building. GEM pays the property owner $15 for each of its 2,000 square feet of rentable space plus a pro-rata share of the $10,000 annual maintenance. What is GEM’s annual rent?
   A. $31,000
   B. $32,000
   C. $40,000
   D. $42,000

14. K pays an annual base rent of $12,000 for her little bookstore as well as an overage percentage of 7.5%. Using the natural breakpoint, if K has gross sales of $120,000, what is her total rent?
   A. $11,100
   B. $11,250
   C. $12,000
   D. $12,900

15. A percentage lease is most typically associated with
   A. industrial property.
   B. multi-family property.
   C. retail property.
   D. single family property.

16. A tenant leases 4,000 square feet of usable space in a warehouse for his auto detailing business. The load factor on the building is 1.08 and the rent is $6.85 per rentable square foot per year. What is his monthly rent for this space?
   A. $2,114
   B. $2,283
   C. $2,466
   D. $2,959

17. An office building has 180,000 square feet of rentable space and 165,000 square feet of usable space. What is the building efficiency?
   A. 91.6%
   B. 96.1%
   C. 1.09%
   D. 1.96%

18. Smallville builds a new sewage treatment plant and raises water rates to pay for it. If a property owner subsequently raises the rent on the tenant in his warehouse, the lease MOST LIKELY contains an escalation clause.
   A. contains an escalation clause.
   B. is a graduated lease.
   C. is an index lease.
   D. is a percentage lease.

19. A tenant leases 8,000 square feet of usable space in an office building. The load factor for that building is 1.08. The annual rent is $9.90 / RSF per year. The listing agent negotiated a lump-sum commission of $0.80 per rentable square foot. How much did the agent earn on this lease?
   A. $6,336
   B. $6,400
   C. $6,842
   D. $6,912

20. A commercial broker negotiates commission on the lease of an office building, half due at signing and the other half due at occupancy. If the property owner does not pay the full commission due under the terms of the contract, many states will allow the broker to
   A. evict the tenant and take possession of the property.
   B. file a lawsuit against the tenant.
   C. file a lien against the property.
   D. garnish the rent payments made to the property owner.
Residential Construction Fundamentals

It is important for real estate licensees to have a working knowledge of a home, its construction, and its systems. This knowledge will aid them in having intelligent conversations with others they encounter and demonstrate their professionalism. This chapter looks at the basics of residential construction from the process of building a new home to completion, as well as the different styles and layouts of houses. It also examines considerations related to energy efficiency and home inspections.

After reading this chapter, you will be able to:

- Identify various parts of a house’s structure.
- Recognize common house designs and styles.
- Identify elements that make up the systems of a house.
- Recall programs related to energy efficiency.
- Describe the purpose of a home inspection.

Key Terms

Amperage
Balloon Framing
Blueprint
British Thermal Unit (BTU)
Building Codes
Certificate of Occupancy
Crawl Space
Footer
Foundation
Framing
Home Energy Rating System
Home Inspection
HVAC
Joists
Permits
Pitch
Platform Framing
Rough-ins
Sheathing
Slab-on-Grade Construction
Sloped Joist
Trusses
Voltage
The Process of Building a New Home

The success of a construction project depends on many factors. Of vital importance is choosing an experienced and reputable builder. Beyond that, the same general steps are followed, regardless of whether the project is a custom-build or a tract house in a large development.

Planning

Once the site is selected, planning and pre-construction begin with the specifications, or specs. These are detailed written documents, usually created by a builder or architect, that describe the requirements and scope of the work, including materials, standards, and expected quality of the finished product. The specs also prescribe the construction methods and project responsibilities. A blueprint is usually developed concurrently. Blueprints are detailed diagrams, drawn to scale, that show the size and position of rooms, walls, doors, stairs, windows, systems, major fixtures, etc. Blueprints are used to evaluate design, determine feasibility, estimate costs, and, ultimately, guide the construction of a structure.

Usually, builders must obtain permits, which are official government documents that acknowledge work a person wants to do on a property and allow it to be done. Inspections generally follow after each type of work has been completed to ensure it complies with building codes and safety rules. Building codes are a means of setting construction standards, requiring builders to use particular methods and materials. A final inspection is also made after all work is done.

Site Work

The first step in the home building process is site work. Here, builders need to consider improvements to make construction viable. For example, they may need to clear trees, dig a basement, and install a rough driveway. Other site work depends on the style, features, and position of the house. If a lot is part of a subdivision, some or all of the site work may already be finished. If a lot is raw land, it will be necessary to trench into public water or sewer lines or dig a well for water and create a leach bed for a septic system. In the latter case, the builder must work closely with the local health department to ensure compliance with all regulations.

Architects and builders must also consider these questions:

- Are there deed restrictions that dictate the style or minimum size of house that must be built?
- Are there easements on which nothing may be constructed? Are there required setbacks that dictate how far back from the street and how far away from neighboring houses the house must be built?

In addition to restrictions and local ordinances, the positioning of the house on the lot should take into account aesthetics and energy conservation. Not only can a house be positioned to take advantage of the best view, but other factors can also influence the direction a house faces. For example, the south side of a house receives the most winter sun.
The Foundation

After site work is finished, next comes the foundation. The foundation is the basic structure on which the rest of the building sits. The foundation holds up the rest of the house, so it's important for it to be strong and dry. Usually, a foundation sits on a base of concrete footers. After a trench is dug, concrete is poured on the solid ground to create a footer that is wider than the structure it will support. Local building codes dictate how to build footers, including their size and placement, based on the ground, the type of foundation, and the frost depth common in the area. Footers go below the freeze line, which is the deepest point that the ground freezes in winter. Typical residential foundation types are concrete slabs, piers and beams, crawl spaces, and basements.

Concrete Slabs

A concrete slab is a foundation made from a layer of poured concrete reinforced with steel rods (called rebar). This type of foundation sits directly on the ground, with only a thin layer of sand or gravel, perhaps with a mesh, waterproofing membrane and/or Styrofoam sheeting to act as insulation. With concrete slab foundations, the builder may use concrete footers, or instead dig additional deep holes into the ground so the continuous pour of concrete produces piers that are connected as one piece with the concrete slab.

Piers and Beams

A pier and beam foundation has columns of concrete, wood, or steel (the piers) resting on footers or another type of reinforced base, with supports of wood or steel (the beams) that span the columns to provide support for the structure. The lower beams that span the piers are called the floor joists. Builders nail the floor and framing support for the walls and ceiling to the floor joists. The piers can be almost flush with the ground or extend into the air. Typically, building codes will limit the height of the piers to discourage using this method to build a house onto the side of a hill.

Crawl Spaces

A crawl space is an unfinished space between the ground and the first floor of a house or other structure that is less than a full story in height. A crawl space is technically not a foundation, but rather a part of another foundation type. Most crawl spaces are the result of a pier and beam foundation where the piers stick out of the ground less than a full story in height.

Basements

A basement is part of a house or building which is partially or entirely below grade (ground level) and is used to support the rest of the structure. Basements are typically at least one full story in height. A basement is formed as a result of space that builders dig first before erecting a house or building. The walls of the basement can be poured concrete or built from concrete blocks or stone. The basement walls sit on concrete footers. One end of the floor joists sits on the ledges or sills of the basement walls around the perimeter of the house. The other end of floor joists (in the middle of the house) sits on some type of support column or beam that sits on the support column. Support columns may be concrete piers, wood or block pillars, or metal floor jacks that rest on a slab or footer.
Framing

The framing is the basic load-bearing skeleton of the house to which interior walls, exterior walls, and roof are attached. Framing also includes the solid support structure surrounding window and door openings. When framing is complete, a person can actually walk around the floor plan of the home, from room to room, to see how the layout feels. The final step in framing is the roof sheathing.

Although builders can use concrete blocks to build a house (particularly one-floor ranches), blocks are usually reserved for commercial buildings. The typical house is wood-framed, although some builders use metal studs such as those used in commercial construction. The three basic types of wood-framed houses are platform, post and beam, and balloon frame.

Platform

In platform framing, the building is constructed one story at a time, with each story serving as a platform upon which to build the next story. Wood studs are cut to the height of each story with horizontal flooring and support across the top of the studs. The studs for the next story are then cut and attached to the flooring. This is the most common type of framing.

Post and Beam

In post and beam framing, beams that sit on top of posts and the outside wall perimeter support the floor for higher stories (and the roof). This is similar to the way a post and beam foundation is constructed. With post supports, fewer interior walls are needed, allowing for larger and more open rooms. Posts, beams, and frame members are heavier than other types of framing, and the wood is often left exposed for decorative purposes.

Balloon

In balloon framing, long vertical studs run from the foundation to the roof of the house. Builders nail horizontal studs (called ledger boards) to these vertical studs to provide support for floor and roof joists. Although balloon framing was common in older multi-story homes, most building codes today prohibit it because of its poor fire-resistant design.

Roofing

The roof is part of the last step in framing a house, and there are several styles of exterior roof design. Three common roof frame types are truss roofing, joist and rafters, and sloped joist. Roof style and pitch can influence the choice of roof frame. Pitch is a roof’s vertical rise in inches, divided by the roof’s horizontal span in feet.

Truss Roofing

Truss roofing consists of several pieces attached together to a triangular structure that creates a beam of support to hold up the roof covering. Trusses are held together by nails, bolts, or metal plates (called gusset plates). A truss must be used when the span or weight of the roof would be too great for a single beam. Trusses are often used because they are less expensive than longer pieces of wood, can be engineered to be stronger than beams, and come to the job site pre-assembled.
Figure 23.1 Roof framing types

**Joist and Rafters**

With **joist and rafters** roofing, joists are supported by outer load-bearing walls and a central load-bearing wall that acts as beams for floor joists. The ceiling joists run horizontally; parallel to the floor. The ceiling rafters begin on the outer load-bearing walls but rise as they come to the center peak of a roof. Where two sets of rafters meet at the peak, there’s only a **ridge board** between them. The rafters are held up by the opposing pressure that each side places on the other.

**Sloped Joist**

With **sloped joist** roofing, joists go from the outer load-bearing walls to a central load-bearing wall that is higher than the outer walls. Instead of having the joists parallel to the floor, the joists actually slope up with the pitch of the roof. There are no rafters because the joists are essentially taking that position.

This type of roof framing allows for **vaulted ceilings** (also called **cathedral ceilings**), which are ceilings that rise as they follow the roofline, extending up into the roof peak. They’re not flat and don’t run parallel to the floor but create a feeling of openness and are ideal for skylights.

**Roof Styles**

These are among the more common roof styles:

- **Gable**. This triangle-shaped roof has two equal sides that meet at the ridge. Also called a pitched roof, gables allow for attic space and vaulted ceilings. The gable may appear on the front of the home, or the side. Gable roofs may have dormer windows.

- **Hip**. This roof has a slope on all four sides, forming a ridge at the roofline. There are many variations of a hip roof, depending on the pitch.

- **Gambrel**. This is typically a two-sided roof with an upper slope that’s shallow and a lower slope that is steeper. Like gables, the slope of the roof may appear on the front or side of the home.

- **Mansard**. This is a combination of a hip and a gambrel roof. The upper slope is essentially a hip roof, and four lower slopes are steep. Mansard roofs often have dormers.
• **Saltbox.** A saltbox is a variation of the gable roof used for walls of different heights.

• **Shed.** This simple roof style has only one slope. As its name indicates, it is often used for sheds but is also commonly seen on porches.

• **Flat.** Flat roofs are most often used for contemporary homes, though also may be found on porches and garages.

### Roofing Materials

After roofers frame the roof, they install *sheathing* to strengthen the roof and serve as a base for exterior weatherproof covering. In home construction, builders generally use plywood or oriented strand board (OSB). After the sheathing is in place, the roof is ready for its final covering. The following are among the most common types of roofing materials:

- **Composition asphalt shingles** are composed of a base material of fiberglass felt with an asphalt coating, followed by granules. Most composition asphalt roofs have lifespans between 15 to 40 years.

- **Wood shingles or shakes** are a traditional roofing material, though more expensive than asphalt. Wood *shakes* are rough and have an irregular, rustic finish; wood *shingles* are milled and appear more regular. Although durable, wood roofs require regular maintenance to remove moss and mildew.

- **Slate** roofs are made of very thin slices of slate rock. The slate pieces are cut into various shapes and sizes and can be found in a variety of colors. Slate roofs are very heavy and very expensive compared to other materials, but if maintained, a slate roof can last for decades.

- **Metal** roofs have been around for a long time and are enjoying a renaissance. While they are generally ribbed steel, a metal roof may imitate the look of other building materials, such as tile. Metal roofs last a very long time, come in a variety of colors and do not necessarily require sheathing.

- **Clay tile** is the oldest known roofing material. These roofs have been known to last for well over 100 years, making them an extremely durable product. Like slate, this durability means that they are heavy and costly.
Rough-Ins

The next phase after framing is completing the rough-ins. Rough-ins are any type of interior work to a house or building that is not part of the finish work. Essentially, these are items vital to the operation of a home that will not be seen because they will be hidden later by the finished walls. Rough-ins include elements such as electrical wiring, plumbing, and heating and air-conditioning.

Interior Finish Work

Once rough-in work has been completed and inspected, the interior finish work may begin. Builders cover ceilings and wall framing with drywall or other material, such as plaster, and then paint them. They lay flooring materials and install lights and light switches, plumbing fixtures, and cabinets, as well as trim and other special finishing touches.

Exterior Finish Work

Work on the exterior goes on for quite some time. After completing the framing and before beginning any rough-in work begins, builders focus on additional exterior finish work to help keep weather and elements out while they complete the rest of the house.

Common exterior coverings include the following:

- **Aluminum siding** is common on older homes. In addition to being relatively inexpensive, aluminum is easy to maintain. The main drawback to aluminum is that it can dent easily and needs to be painted after the factory finish wears off (about 10-15 years).

- **Vinyl siding** is a more common siding today. It is relatively inexpensive and easy to maintain. Today’s vinyl can imitate more expensive wood siding or shingles. Vinyl does not dent like aluminum, and the finish and color are molded into the material so there is no need to worry about the finish wearing off. Vinyl can, however, fade in the sun or crack from severe cold weather. Vinyl siding can typically last 25 years or so.

- **Wood siding** (also called lap siding or clapboard) is common on older homes because it is tough, economical, and it enhances the appearance of a home. It is more expensive than vinyl or aluminum. It will last longer but needs regular maintenance and painting. Wood siding also adds insulating value that aluminum and vinyl do not. The wood can be left natural, stained, or painted.

- **Wood shakes** and **wood shingles**, usually cedar or redwood, are popular choices for homes but are more expensive than wood siding. With some maintenance, wood shakes and shingles can last 50 years or more.

- **Stucco** is a popular material used to cover houses. Stucco is durable because it has no seams to let water or moisture in, but it can crack from repeated freeze-thaw cycles. Stucco can be applied over masonry block walls or over hardboard siding with wire mesh. It gives a good outward appearance at about half the cost of brick.

- **Brick and stone veneer** sidings are the most expensive types of siding and, arguably, the most attractive and the most durable. Brick and stone are easy to maintain—even cleaning is rarely necessary—although older brick and stone exteriors may show signs of deterioration from the weather and water. If older brick siding has missing or crumbling mortar joints, it must be replaced with new mortar through a process called tuckpointing.
Completion

During the completion stage, it is time to finish outside features like patios, driveways, and landscaping. One of the most important completion items is to clean up the worksite and haul away debris. Perhaps the best gauge of when a house is completed is when the appropriate authorities have approved the structure and issued a certificate of occupancy. A certificate of occupancy also confirms:

- The construction matches submitted plans.
- All applicable zoning laws, ordinances, and regulations have been followed.
- All required approvals were obtained and the necessary paperwork filed.
- All required fees have been paid.

Styles of Houses

There are two ways to define the style of a house:

- Exterior appearance
- Functional layout

Exterior Appearance

When discussing the exterior appearance of a home, there are basic architectural styles that are popular:

- **English Tudor** homes are recognizable by the mixture of half timbers and stucco, or a material that looks like stucco, above and stone or brick below. **Half timbering** is a construction method in which the external walls have exposed wood framing constructed of timber frames, with other materials such as plaster or brick filling the space between them.

- **American colonial** is a term used widely to describe any traditional two-story house. This is a broad descriptor that encompasses Georgian (typically symmetrical brick with a hip roof), Federal (usually brick or clapboard with a flat or shallow hip roof), Dutch (often 2 1/2 stories with a gambrel roof), and Southern (usually larger with columns).

- **Spanish-style** embraces a number of eras and styles, though the most distinguishing features include the use of stucco as well as clay tile roofs.

- **Modern contemporary** is an extremely broad category that can encompass a range of styles, although there are some common characteristics, such as clean lines, open floor plans, asymmetrical shapes, and limited ornamentation.

- **Cape Cods** are typically small, symmetrical one-and-one-half-story homes with a steep gable roof sloped to the front of the house, often with dormer windows.

- **Ranch** homes are perhaps the most versatile of all house styles. Tiny or sprawling, this one-story home generally has a relatively low sloping roof, usually gable or hip.
Figure 23.3 Architectural house styles
Functional Layout

In addition to these basic architectural styles, functional layouts also serve to describe a home. Some of these are associated so closely with an architectural style, they share a common name:

One-Story

A one story residence, also called a ranch, has one level of living area. The roof structure generally has a medium slope. The attic space is limited and is not intended as a living area.

One-and-One-Half Story

A one-and-one-half story residence, also called a Cape Cod, has two levels of living area. Characterized by a steep roof slope and, often, dormers, the area of the upper level, whether finished or unfinished, usually equals 40% to 60% of the lower level.

Two-Story

A two story residence has two levels of finished living area. The area of each floor is approximately the same. The roof structure has a medium slope. The attic space is limited and not designed for usable living area.

Two-and-One-Half Story

A two-and-one-half story residence has three levels of living area. Having a steep roof slope with dormers, the third floor, whether finished or unfinished, usually equals 40% to 60% of the second floor.

Two-Story Bi-Level

A two story bi-level residence has two levels of living area. Unlike a conventional two-story, the lower level is generally partially below grade and may be partially unfinished. A distinguishing characteristic is its split-foyer entry. One drawback to this style is that every time you enter the home, you must immediately go up or down a flight of stairs as you enter half-way between the floors.

Split-Level

A split-level residence has three levels of finished living area: Lower level, intermediate level, and upper level. The lower level is immediately below the upper level, as in a two story. The intermediate level, adjacent to the other levels, is built on a grade approximately four feet higher than that of the lower level.

There are a variety of possible combinations of architectural styles and functional layouts.
### Exterior Parts
1. Flashing
2. Fascia
3. Eaves
4. Soffit
5. Siding
6. Lintel
7. Foundation
8. Gutter
9. Downspout
10. Gable
11. Corner Board
12. Porch
13. Shed Roof
14. Post
15. Double Hung Window
16. Window Frame
17. Window Sash
18. Sill
19. Door

### Interior Parts
1. Rafters
2. Studs
3. Beam or Girder
4. Joists
5. Header
6. Bearing Wall
7. Sheathing
8. Drywall, Plasterboard, or Wallboard
9. Basement/Crawlspace
10. Foundation Wall
11. Footer (below grade of foundation wall)
12. Subfloor
13. Sill Plate
Systems of Houses

There are three basic systems in a house:

• Electrical
• Plumbing
• Heating

These are typically referred to as the "mechanicals" of a house.

Electrical System

The electrical system of a house is comprised of many elements, such things as the wiring, distribution box, circuit breaker box, circuit breakers, fuses, lights and lighting fixtures, light switches, and wall outlets. The amount of amperage (amps) of electricity available to a house is determined by the amount of power the electric company transmits through the wires into the house. While many older homes have 100-ampere service or less, the standard for new construction is 200 amps. The higher the amperage of the house, the more electrical devices can be used.

A volt is a measure of electric potential. For most electrical appliances, a voltage of 110-120 is needed. But for electric ranges, large air conditioners, large tools, clothes dryers, for example, the requirement is 220 volts. The increased capacity requires the use of a larger 220-volt outlet, called a pigtail. Sometimes, these large electrical appliances are directly wired into the electrical system. Electrical wiring for a structure must meet minimum standards imposed by the local jurisdiction as set forth in the building codes.

For Example

Many clothes dryers require a special line carrying 220 volts of electricity. Actually, most homes have 220 volts running to the home, but it is split in half at the distribution box to provide multiple 110-volt lines. Combined voltage lines provide 220-volt service when needed.

Warning Signs

As a real estate licensee, you should open the distribution box or circuit breaker box to check for obvious signs of trouble. This is not intended to replace a home inspection, and licensees should never pass themselves off as experts. They would, however, do buyers a great service if they persuaded them to get a home inspection because they saw something that they knew didn’t look right. Some of these warning signs are patched wiring in the box, sparks or light flashes, sounds coming from any part of the electrical system (including hums), and any part of the electrical system (including a cord) that is warm or hot to the touch. Additional warning signs are installed fuses that are rated higher than the amp capacity of a circuit, and lights that flicker when additional lights or devices are turned on.
Plumbing System

The plumbing system of a house is comprised of many elements, such things as the piping, drains, cleanouts, vents, valves, faucets, sinks, toilets, tubs, showers, and hot water tank (gas or electric). The piping includes all supply lines (cold water), hot water lines, and wastewater lines (sewer lines). Sometimes, gas lines are also referenced as part of the plumbing system.

It's important to understand that supply lines carry water under pressure from the source. Hot water tanks are specially designed to retain this pressure when delivering hot water. Wastewater lines, on the other hand, rely on gravity to move waste into the sewer. That's why vents are so important. Not only do they let sewer gases escape from the house, but they also allow atmospheric pressure to come in and push wastewater down the pipes (sewer pipes must be sloped according to code).

Although washing machines and dishwashers are connected to the plumbing, they are generally not included as part of the plumbing system. Their valves, connections, and drains may be checked for leaks, but these machines are not routinely inspected except as other mechanicals or other systems (garbage disposals may or may not be included as well).

Warning Signs

As a real estate licensee, you should check the various plumbing fixtures to make sure that they work. Again, this is not intended to replace a home inspection, and licensees should never pass themselves off as experts. Some of the things to look for are faucets that leak, drains that leak, toilets that don't flush properly, drains that are slow, drains that have odors emanating from them, drains that gurgle or make other noises as they empty, and excessive putty on fixtures or pipe joints. Additional warning signs are lack of water pressure when multiple faucets are turned on and/or a toilet is flushed, corroded fixtures or pipes, and lead pipes.

Heating System

The heating system of a house is comprised of several elements, such as a furnace or heat pump, flue, ducts and ductwork, registers, and thermostat. Depending on the type of fuel the system uses, there may also be electrical connections, gas lines, or oil/fuel storage. For houses with air conditioners, the air conditioning system is generally considered as part of the heating system because they usually share a common ductwork system. In fact, it's common to refer to all of these system components collectively as heating and cooling systems or HVAC (heating, ventilation, and air-conditioning) systems. Ventilation is added to the mix because the systems can also provide fresh air and cleaned air to the house as they circulate the heated or cooled air. Indoor air quality (IAQ) is important to consider, and in addition to standard filters, many homes incorporate electronic and static filters to clean the air.

Although window air-conditioners, space heaters, and fireplaces produce some of the same results as the HVAC system, these items are not included as part of the HVAC system. They are generally considered separate items for inspection purposes.
What Size Furnace or Air-Conditioner?

Determining the correct size of furnace or air conditioner that a house needs can be a difficult task—even for a professional. That's because some of the variables are unknown. Not only must the size of the house be taken into consideration, but also the number of windows, type of foundation, amount of ventilation, and the biggest unknown—how well the house is insulated. The key for a furnace is determining how fast heat moves out of the house and, then, the amount of heat necessary to keep the house at the desired temperature. A British Thermal Unit (BTU) is the common measurement of heating capacity, calculated as the amount of heat needed to raise the temperature of one pound of water by one degree Fahrenheit. A furnace is classified by its BTUs, and its efficiency is measured by how many BTUs it loses.

For Example

When evaluating a 2,000-square foot house, an HVAC specialist determines the furnace loses about 60,000 BTUs per hour (60K BTUs). He could install a 60K BTU furnace, but then the furnace would have to run constantly. Instead, HVAC specialists typically add 20-30% to their estimates. So here, the house could maintain its temperature with an 80K BTU furnace. To find the efficiency of the furnace, divide the heat loss by the furnace size. For example: 60K ÷ 80K equals 0.75 or 75%. This furnace would run about 75% of the time.

Air-conditioning calculations are different than those for a furnace because additional factors are considered. As a general rule, every 500-1,000 square feet of living area needs one ton of air-conditioning capacity, which is equal to 12,000 BTUs. Thus, this 2,000 square foot home could be cooled adequately by a two-ton air-conditioner.

Types of Furnaces

There are many systems that can distribute heat to the house. A forced-air furnace has a fan or blower that moves the air through the ductwork. A gravity furnace relies on the natural phenomenon of heat rising to distribute it. Hot water and steam systems used a boiler in which water is heated. The hot water or steam is circulated through pipes into radiators or other devices that radiate heat to warm the room. Additional types of heat sources can include wall furnaces, electric baseboard heating units, and wood-burning stoves.

Electric heat pumps are another alternative to traditional heating and cooling systems. With heat pumps, the same unit provides heat in the winter and cooled air in the summer. There are advantages and disadvantages to the system. The main advantages are that it uses energy more efficiently than a furnace that burns fuel, and that only one unit is needed instead of two. The main disadvantages are that it can be more expensive to obtain and operate than a furnace, and heat pumps aren’t effective when temperatures drop below freezing for extended periods.

Warning Signs

As a real estate licensee, you should test the thermostat to see if the furnace and/or air-conditioner are operable. Some of the warning signs are a furnace that runs constantly instead of cycling on and off with the temperature in the room, as well as loud noises coming from the ductwork—especially a bang after the furnace cycles off.
This could indicate that the furnace does not have an adequate cold air return and is trying to suck more air. Both of these problems may be symptoms that the furnace is undersized or overworked. Additional warning signs could be furnaces that look old or that have old inspection dates written on them. Also, a furnace that is dirty or old and worn can give off carbon monoxide gas, which is a silent killer that should be checked for by an expert.

### Evaluating Energy Efficiency

**Energy efficiency** is impacted by which materials are used, where a house is built, how it is positioned on the site, and how it is designed. Energy efficiency considers both the long-term cost savings to homeowners as well as environmental sustainability, which is the wise use of resources with an eye on future generations.

The Residential Energy Services Network (RESNET) was founded in 1995 as an independent, nonprofit organization that helps homeowners reduce the cost of their utility bills by making their homes more energy efficient. RESNET developed the **Home Energy Rating System**, or **HERS Index**, which is a nationally recognized scoring system for measuring a home’s total energy performance. Various green certification programs use the HERS Index, including ENERGY STAR. A certified HERS rater, or energy auditor, evaluates the home’s energy features—including heating, cooling, water heating, and lighting—against an idealized standard for that specific geographic region of the country and its climate. A computer program analyzes the data and issues a **HERS Index score**. The lower the score, the **more energy efficient** the home, thus saving on energy costs. For example, a home with a score of 70 is **30% more efficient** than the standard home. A home with a score of 0 is a **net zero energy home**, which means it produces as much energy through renewable sources—such as a solar or wind—as it consumes.

For example, a home with a score of 70 is **30% more efficient** than the standard home. A home with a score of 0 is a **net zero energy home**, which means it produces as much energy through renewable sources—such as a solar or wind—as it consumes.

The most common program that promotes sustainable practices in construction is **ENERGY STAR**. This is a U.S. Environmental Protection Agency (EPA) voluntary program intended to help businesses and individuals save money and protect the climate through superior energy efficiency. ENERGY STAR certification considers:

- Effective insulation and high-performance windows.
- Tight construction and sealing of ducts.
- Efficient heating and cooling equipment, and other energy systems, such as solar.

ENERGY STAR ratings also apply to appliances, however, so beware of those who put high-efficiency appliances in a house and call it an ENERGY STAR house. To be certified under ENERGY STAR, homes should reduce energy use by **at least 15%** in warmer climate zones and by **at least 20%** in northern climate states.

### Home Inspections

A **home inspection** is a visual examination of the physical structure and systems of a home. The home inspector is inspecting the house for quality and condition. To be a good home inspector, one needs to have knowledge of the building process, building codes, parts of a home, and systems of a home. A home inspection will cover many areas of the home: Roof, mechanicals, and the foundation. It is different than a building inspection because the home inspector is not necessarily looking for code compliance. Code deficiencies will be pointed out, but this is not the primary focus of a home inspection.
The home inspection is geared towards finding items that are **dangerous**, items that are **damaged**, and items that **don’t work**. The purpose of a home inspection is not to find every possible imperfection in the home—even new homes have imperfections. By concentrating on potential problems, the home inspection is trying to help a home buyer (or owner) make intelligent choices. Homes cannot “fail” a home inspection. The purpose of the home inspection is information and discovery. Upon completion of a home inspection, the buyer/owner should know:

- Repairs that need to be done immediately
- Potential future repairs that may be needed
- Repair priorities
- Recommended major/minor repairs
- Recommended preventive maintenance steps
- Significant deficiencies are in the home
- Risks of hidden damage
- Unsafe conditions
- Areas that may warrant further investigation

**Quality Inspection**

Anyone who claims to be skilled in the area can inspect a home, but this is where potential problems can arise, both in the quality of the inspection and in the area of liability. The best way to obtain a quality inspection is to hire a professional with a good reputation in the area. A person can also seek out home inspectors that have some sort of certification or belong to a professional organization. This indicates a level of training or expertise and that the inspector is required to follow the organization’s guidelines and ethics.

The American Society of Home Inspectors® (ASHI) is the oldest and leading non-profit professional association for independent home inspectors. ASHI members must pass two written technical exams and perform at least 250 home inspections, plus obtain continuing education credits. Several other associations also exist.

A person might also choose to have an **engineer** inspect a home. The National Academy of Building Inspection Engineers (NABIE) is a non-profit, professional society which accepts as members only state-registered professional engineers specializing in the practice of building inspections. In addition to standard home inspection analysis, licensed engineers are also allowed to evaluate overall structural soundness and mechanical system adequacy as of the date of the inspection.

**Potential Liability**

A home inspection is generally not warrantied and does not provide any type of guarantee on the items or systems inspected. The home inspector provides a report to the buyer or homeowner stating the condition as of the date of the inspection. A homeowner may choose to obtain a **home warranty**, purchased by buyer or seller, at closing. A home inspection company may offer this or make a referral, or the broker can refer the homeowner to a home warranty company.
Since home inspectors hold themselves out as having a higher level of competence, they are held to a higher standard of culpability. Liability can, therefore, be a problem for home inspectors if they miss a serious problem with a home. Liability can also become an issue if someone passes himself off as a home inspector, or others believe that he is a home inspector and rely on his opinion. Such misrepresentation or misunderstanding can result in serious trouble if a major defect in a home is missed. That's why it is very important for real estate licensees to be careful so as not to be perceived as giving home inspection advice. Licensees should instead urge potential buyers (or sellers) to have their own professional home inspection done.

**Areas Covered by a Home Inspection**

A thorough home inspection covers the areas discussed in this chapter and more. From the roof to the foundation, and all parts and systems in between, home inspections are designed to let buyers know what they're getting into. A standard ASHI home inspection includes a visual inspection and written report on all home systems (heating, air-conditioning, plumbing, and electrical); the foundation, basement, and visible structure; the roof (including gutters and downspouts), attic, and visible insulation; windows and doors; interior and exterior walls; and floors and ceilings.

Other items that are usually inspected as part of a home inspection include garages, sidewalks and driveways, cabinets and countertops, appliances, fireplaces, security systems, and telephone systems.

Most inspectors also offer additional tests (often at additional cost) for wells, septic systems, drinking water, air quality, termites, lead, radon, and any number of other items.
Chapter Summary

1. **Steps in building a new home** include site work, foundation, framing, roofing, rough-ins, interior finish, exterior finish, and completion. **Foundation types** include concrete slabs, piers and beams, crawl spaces, or basements. **Framing types** include platform, post and beam, and balloon. **Roofing types** include truss, joist and rafters, and sloped joist. **Roof styles** include gable, hip, gambrel, mansard, saltbox, shed, and flat. **Rough-ins** include things like electrical wiring, plumbing, heating and air-conditioning. **Interior finish** includes things like drywall, floor coverings, light switches, plumbing fixtures, kitchen cabinets, and other finishing touches. **Exterior finish** includes finishing the exterior of the house, whether it be brick, stucco, siding, etc. **Completion** typically includes outside features and landscaping, clean-up of the worksite, all final inspections, and when the house is approved for habitation.

2. Usually, **permits** (official government documents that acknowledge work a person wants to do on a property and allow it to be done) will need to be obtained and inspections will follow after each type of work has been completed to ensure that the work complies with all building codes and safety rules. **Building codes** are a means of setting construction standards, requiring builders to use particular methods and materials.

3. **Architectural styles** include American colonial, English Tudor, Spanish-style, Cape Cod, traditional ranch, and modern contemporary. **Functional layouts** include Ranch (1 story), Cape Cod (1 1/2 story), split level (multi-level, short stairs), bi-level (2 levels, one sunken, no basement), and two-story.

4. The **electrical system** is comprised of many elements, which include the wiring distribution box, circuit breaker box, circuit breakers, fuses, lights and lighting fixtures, light switches, and wall outlets. **Plumbing** requires a system of pipes for water supply and drainage. Common types of **heating systems** include: Hot water system, steam system and forced warm air system. Furnaces are either electric, oil, or gas. To determine the appropriate size of the furnace, it’s important to know how many British Thermal Units the house loses per hour. A **British Thermal Unit (BTU)**, the common measurement of heating capacity, is the amount of heat needed to raise the temperature of one pound of water by one degree Fahrenheit.

5. The **Home Energy Rating System**, or HERS Index, which is a nationally recognized scoring system for measuring a home’s total energy performance. The lower the HERS score, the more energy efficient the home. A **net zero energy home** produces as much energy through renewable sources as it consumes. The most common program that promotes sustainable practices is the EPA’s **ENERGY STAR**. A certified ENERGY STAR home reduces energy use by at least 15% (warmer climate zones) or 20% (northern climate states).

6. A **home inspection** should be conducted by a trained professional. A home inspection is not an appraisal and it is not intended to determine if the property meets the specifications of local building codes. Nor does it provide a warranty on any of the items inspected. It is intended to identify issues or potential issues related to major systems and other elements of the house that are not working or that may be unsafe. A standard home inspection includes a visual inspection and written report on all home systems (heating, air-conditioning, plumbing, and electrical); the foundation, basement, and visible structure; the roof (including gutters and downspouts), attic, and visible insulation; windows and doors; interior and exterior walls; and floors and ceilings.
Chapter Quiz

1. Detailed building diagrams used to evaluate design, determine feasibility, and guide construction of a structure are called
   A. blueprints.
   B. building codes.
   C. plot plans.
   D. specifications.

2. Electrical wiring for a structure must meet minimum standards imposed by the local jurisdiction as set forth in the
   A. blueprints.
   B. building codes.
   C. permits.
   D. specifications.

3. A house that has neither a basement nor a crawlspace has what kind of foundation?
   A. pier and beam
   B. platform
   C. post and beam
   D. slab-on-grade

4. In which type of construction is a house built one story at a time, with each story serving as a base for the next?
   A. balloon
   B. platform
   C. post and beam
   D. slab-on-grade

5. Which type of roof allows for vaulted ceilings?
   A. balloon roofing
   B. ceiling joists and rafters
   C. sloped joists
   D. truss roofing

6. The rise of the roof in inches divided by the space of the roof in feet defines its
   A. fascia.
   B. header.
   C. pitch.
   D. style.

7. During which stage of construction would the home’s plumbing be installed?
   A. framing
   B. interior finish
   C. sheathing
   D. site work

8. Which of these is NOT a basic structural component of a building?
   A. foundation
   B. framing
   C. roof
   D. electrical

9. The load-bearing skeleton of a structure to which the interior walls, exterior walls, and roof system are attached is called
   A. the building envelope.
   B. drywall.
   C. framing.
   D. the girder.

10. The common measurement of heating capacity for furnaces is the
    A. amperage.
    B. BTU.
    C. CFM.
    D. voltage.

11. The underground base that supports a foundation is called a
    A. footer.
    B. girder.
    C. pitch.
    D. truss.

12. Which type of roof has two planes of equal size that meet at the ridge?
    A. gable
    B. gambrel
    C. mansard
    D. saltbox
13. Electrical wiring, plumbing, and heating ductwork installed in a house as a step in the construction process, and later connected to their main service points and hidden from view, are known as
A. framing.
B. interior finish.
C. rough-ins.
D. temporary utilities.

14. After all inspections have been made and a property has been deemed fit, what is issued to builders?
A. builder's certificate
B. certificate of occupancy
C. permit
D. specification

15. A Cape Cod-style home is typically
A. one story.
B. one and a half stories.
C. split-level.
D. two stories.

16. Which is NOT a design feature of a contemporary-style house?
A. asymmetrical shapes
B. half-timbering and stucco
C. limited decorative trim
D. open floor plan

17. Of these, which describes the functional design of a house, NOT its style?
A. Cape Cod
B. Colonial
C. Split-level
D. Tudor

18. An energy auditor finds the HERS rating on a new home to be 60. This means that the home is
A. 40% less energy efficient than average.
B. 40% more energy efficient than average.
C. 60% less energy efficient than average.
D. 60% more energy efficient than average.

19. For large electrical appliances such as a range or clothes dryer, what is the voltage required?
A. 220
B. 210
C. 200
D. 110

20. Before a septic system can be installed, the property must pass what kind of test?
A. condensation test
B. density test
C. evaporation test
D. percolation test
For many people, math is one of the scariest parts of a state licensing exam. While calculations represent a relatively small portion of the exam, the best way to alleviate math anxiety is with practice.

The Formulas

The formulas were created to address two basic needs:

1. Through the formulas, we have you deal with words more than numbers. Many people feel that they cannot “do” math, but when math is presented as words, much of that anxiety is diminished. The formulas will not magically eliminate math anxiety overnight, but they are a great start.

2. The formulas were created to use the simplest approach to each math calculation. They are not always the shortest method as, typically, they do not omit even the smallest step. However, they do break down calculations to a more easily understood process. There may be another way to solve the problem. Always use the formula with which you are most comfortable.

This section contains the basic formulas you need to know to answer the math questions on a real estate sales license exam. Sample problems may be worked in class. Following this section are additional math exercises and a math quiz with answers to test your skill.

For additional study help, Hondros Learning’s Real Estate Math CompuCram®, online Exam Prep, is available at www.compucram.com.
Formula 1: Percent Problems

Many questions on the state exam require the ability to calculate various percent problems. Two approaches are presented here. Adopt whichever method you find most comfortable.

Line Approach

• Sale Price or Loan Amount x Percentage = Part or Annual Interest
• Part or Interest ÷ Percent = Sale Price or Loan Amount
• Sale Price or Loan Amount ÷ Percentage = Part or Interest

T (Circle) Approach

Same Formula as Line Approach

• Part ÷ Whole = % (TGIF…Top Goes In First)
• Part ÷ % = Whole (TGIF)
• Whole x % = Part

For Example:

Read the question carefully.
Boss Realty sold its listing for $105,000. If a 6% commission was charged, what commission would Boss Realty earn?

Solve the problem:

Part (Commission) = 6% x $105,000
0.06 x $105,000 = $6,300

The commission earned was $6,300.

Sample Problems (to be worked in class)

1. A property listed for $100,000 sold in a co-op transaction for $90,000. If the commission rate was 7% and the brokerages split it evenly, how much did each company get?

2. A company sold another company’s listing. It received 50% of a six percent commission. If the company receive $2,250, what was the price of the home?

3. If the sales agent received half of the total commission, or $5,122, and the home sold for $157,600, what rate did the broker charge for commission?

4. A buyer purchasing a home for $326,000 makes a down payment of $65,200. What is the loan-to-value?

5. A borrower makes a monthly loan payment of $600, $550 of which covers interest. If the interest rate is 4%, what is the balance of the loan?
Formula 2: Points

A point is defined as one percent of the mortgage, or loan, amount. On the exam, points may be referred to as “discount points” or “loan origination fees.”

You will need to calculate the loan amount (sale price – down payment). The question may also give you the sale price on a VA transaction. Since the VA requires no down payment, the sale price and mortgage amount are the same.

For Example:

Read the question carefully:

A buyer is purchasing a property for $250,000 and will make a $60,000 down payment. If charged two points, how much will the buyer owe in points?

Solve the problem:

Part = Whole x %

First, determine the loan amount:

$250,000 (Sale Price) – $60,000 (Down Payment) = $190,000

Part = $190,000 x 2%:

0.02 (2%) x $190,000 = $3,800

The amount owed in points is $3,800.

Sample Problems (to be worked in class)

1. A buyer is purchasing a property for $100,000 and will make a 20% down payment. If charged two points, how much will be owed in points?

2. A property is being financed through the VA. If the sale price is $75,000 and the points are four, the points will total what dollar amount?

3. J purchased a property for $125,000 and received an 80% loan. He paid $3,000 for points. How many points did J pay?
Formula 3: Property Taxes

The question on the state exam will ask you to calculate the property taxes on real estate. You will receive three pieces of information:

1. The market value or appraised value of the property
2. The assessment level
   - Property taxes are referred to as *ad valorem* taxes. *Ad valorem* means “as per value” and taxes are based on the assessed value of a property.
3. “Mills” (or an equivalent tax rate, such as $1 per $1,000 of value)
   - One mill equals $1 per $1,000 of assessed value (1 mill = $1/1,000 or 0.001).

For Example:

Read the question carefully:
A property is appraised at $380,000 and assessed for tax purposes at 35% of value. Calculate the annual taxes if the mills total 65.

Solve the problem:

\[
\text{Part} = \text{Whole} \times \% \\
35\% \times 380,000 = 133,000 \text{ assessed value} \\
133,000 \div 1,000 (\text{mill} = \$1 \text{ per } \$1,000) = 133 \text{ (cost of 1 mill)} \\
133 \times 65 \text{ mills} = 8,645 \\
or \\
\text{Part} = \text{Whole} \times \% \\
133,000 \times 0.065 = 8,645 \\

The annual taxes are $8,645.

Sample Problems (to be worked in class)

1. A property is appraised at $150,000 and assessed for tax purposes at 35% of value. Calculate the annual taxes if the mills total 80.

2. The assessed value of a property is $35,000 and the annual taxes are $2,380. How many mills were charged on this property?

3. A home is valued at $100,000 and assessed for tax purposes at 35% of value. If mills are 47.5, calculate the annual taxes.
Formula 4: Prorations

First, a simple definition of proration is the cost of a financial item divided between two parties, such that each pays a share of it. On the exam, the financial item will usually be property taxes (between buyer and seller), insurance premiums (between seller and insurance company), or mortgage interest (between seller and lender).

There are two types of years used in proration:

1. A calendar, or 365-day year—In these problems, the first step is to calculate the daily cost of the item in question. Always take the daily rate to four places past the decimal point. Next, calculate the actual number of days in question. Finally, multiply the daily rate by the number of days.

2. A statutory, or 360-day year—In these questions a monthly rate is used so your first step is to calculate the monthly rate. You should again calculate to four places past the decimal point. Next, calculate the number of months in question. The problem will use simple closing dates, like the 15th or 30th, so you can use a whole or half month. Finally, multiply the monthly rate by the number of months.

Remember these rules:
- Always use a 365-day year unless the exam says otherwise.
- Always calculate the math to four places past the decimal point and then adjust the final answer.
- The seller always pays for the day of closing.
- In most states, property taxes are an accrued item. This means taxes are paid in arrears, or after use. Taxes are a minimum six months behind. If the question does not say that the previous six months are paid, calculate the number of days in that six-month period, as well.

For Example:

Read the question carefully:
The sale of a property will close on May 10. Taxes are $3,600 per year and are paid through the last half of the previous year. Calculate the seller’s share of taxes using a 365-day year.

Solve the problem:

Step 1: Daily Tax Rate = $3,600 ÷ 365 = $9.8630 Daily Rate

Step 2: Number of Days = Jan. 31 + Feb. 28 + Mar. 31 + Apr. 30 + May 10 = 130 Days

Step 3: Amount Owed = 130 Days x $9.8630 = $1,282.19

The seller owes $1,282.19 in taxes.

Sample Problems (to be worked in class)

1. The sale of a property will close on April 30. Taxes are $1,575 per year, and are paid through the last half of the previous year. Calculate the seller’s share of taxes using a 360-day year.

2. Property taxes on a home are $2,200 per year. They are paid through the first half of the year. The property has been sold and the closing will take place August 1 of the same year. What amount of prorated taxes will be due to the buyer?

3. The premium for two-year insurance coverage on a home is $460. The policy was purchased and paid for August 1 two years ago, and a closing will take place June 2 of this year. Using a 365-day year, calculate the seller’s credit.
Questions on the state exam use different types of measurements relating to building lots, fencing, and concrete.

The five types of measurements you need to know are:

1. **Front Feet**: The portion of the lot that faces the street. In a measurement, frontage is always the *first* number (a 65' x 150' lot has 65' front feet).
2. **Square Feet**: Length multiplied by width (65' x 150' = 9,750 sq. ft.).
3. **Acreage**: There are 43,560 square feet in an acre. Calculate the square feet of the lot, then divide that number by 43,560 (65' x 150' = 9,750 sq. ft. ÷ 43,560 = 0.2238 acres).
4. **Linear Footage**: This is simply the length in feet (a 20' x 30' garden will take 100 linear feet of fencing).
5. **Cubic Feet/Yards**: Length multiplied by width multiplied by depth equals cubic feet. Cubic feet divided by 27 results in cubic yards. (120' x 10' x 0.3333' = 399.96 cubic feet ÷27 = 14.8133 cubic yards).

For Example:

Read the question carefully:
A property measures 230 feet x 310 feet. If it sells for $14,000 per acre and the commission is 6.5%, how much is the commission?

Solve the problem:

\[
\text{Part} = \text{Whole} \times \% \\
\text{Part} = 1.6368 \text{ Acres} \times 0.065 = 0.107672 \\
\text{Part} = 1,489.488 \\
\text{The commission earned is $1,489.49.}
\]

Sample Problems (to be worked in class)

1. What would a commercial lot, 150' x 600', priced at $2,000 per front foot cost? What would it cost at $2.50 per square foot?
2. If a bag of concrete makes one cubic yard, how many bags will it take to pour a 60' x 4' x 4" sidewalk?
3. A lot measures 80' across the back, 50' deep, and 110' across the front. What is the sq. ft. of the lot?
Formula 6: Transfer Tax (Conveyance Fee)

Transfer tax is a tax charged, generally to the seller, on the sale of the property. Most jurisdictions base the tax on the full purchase price of the property, often stated as an amount of money per each $1,000 of transaction value or fraction thereof.

For the purpose of these examples, we’ll use a rate of $1 per thousand dollars of sales price or fraction thereof.

Exam questions try to obscure the sale price by adding down payment, mortgage, or other information to the question that you do not need. Use the sales price only.

For Example:

Read the question carefully:
A seller is selling his home for $168,500. The buyer will make a $20,000 down payment and borrow $148,500 from the bank. What is the transfer tax?

Solve the problem:
$168,500 purchase price ÷ 1,000 = 168.5 or, accounting for the fraction, 169 taxing units
169 x $1.00 = $169 transfer tax

Sample Problems (to be worked in class)

1. A buyer is purchasing a home for $149,900. He will make a $25,000 down payment and will borrow $124,900 from a local savings and loan association. What will the amount of the transfer tax be?

2. A home sold for $147,500. The seller agreed to carry a second mortgage for the buyer in the amount of $20,000. Calculate the transfer tax.
Formula 7: Sections

The rectangular (government, military) survey system is one method of property description. It uses terms such as sections and townships.

There are two types of math problems on sections:

1. You may be given a description and asked to calculate the number of acres in that particular area. Here, it is important to remember that the total number of acres in a section is 640.

2. You may be shown a diagram of a section and asked to write the description.

For Example:

Read the questions carefully:

1. Calculate the number of acres in the parcels described as the NW 1/4, NE 1/4 of section 32, and the NW 1/4, NE 1/4, NE 1/4 of Section 33.

Solve the problem.

\[
640 \div 4 \div 4 = 40 \text{ Acres}
\]

\[
640 \div 4 \div 4 \div 4 = 10 \text{ Acres}
\]

\[
40 + 10 = 50 \text{ Acres}
\]

There are 50 acres total in the two parcels.

2. Write the description for the shaded area.

This description for the shaded area would read W 1/2, NW 1/4 of the section.

Sample Problems (to be worked in class)

1. Write a description for the shaded area:

2. Calculate the number of acres in the parcels described as the N 1/2, NW 1/4, and the SW 1/4, NW 1/4, NE 1/4 of Section 33.

3. A parcel described as the S 1/2, NE 1/4, NW 1/4 sells for $31,500 per acre. If the commission rate is 6%, calculate the commission.
Formula 8: Capitalization

With capitalization and the GMRM, you will be required to calculate the value of the property based on its ability to generate income. Capitalization uses net income. You may be required to use different steps to find net income, depending on the question. Be familiar with the following terms, which you may see in some of the questions.

- **Potential Gross Income**: The income a property would generate if every unit was occupied 100% of the time.
- **Effective Gross Income**: Potential gross income, minus vacancy and collection losses.
- **Net Income**: Effective gross income, minus building expenses.
- **Capitalization Rate**: The rate of return on an investment.

Depreciation and annual debt service (monthly payment) are not considered building expenses and should not be used if they are included in the problem. They are owner expenses. These problems use only operating expenses.

The formula for capitalization is remembered as *IRV*:

\[
\text{(Net) Income ÷ Rate} = \text{Value}
\]

**For Example:**

Read the question carefully:
A property could generate $200,500 in annual income. The building has an 8% collection loss, monthly expenses of $4,200, and the capitalization rate is 9%. What is the value of the property?

Solve the problem:
- $200,500 (Potential Income) – $16,040 (Losses of 8%) = $184,460 (Effective Income)
- $184,460 (Effective Income) – $50,400 (Annual Operating Expenses: $4,200 x 12) = $134,060 (Net Income)
- $134,060 (Net Income) ÷ 9% (Rate) = $1,489,555.5555 (Value)

The value of the property is $1,489,556.

Sample Problems (to be worked in class)

1. A property has an annual income of $50,000 and monthly building expenses of $2,500. Annual debt service is $16,000 and depreciation is 3% of value. Using a capitalization rate of 8%, determine the value of the building.

2. An apartment building has 10 units, each of which rents for $600 per month. The building has an occupancy rate of 90%, monthly building expenses are $500, and depreciation is 2%. Determine the highest price the investor will pay if he demands a 9% rate of return on his investments.
Formula 9: GRM

For state exam purposes, the question may refer to a GRM, or gross rent multiplier, for some properties. A GRM uses annual income to derive and apply a GRM. Unlike capitalization in the previous formula, the GRM uses gross income.

\[
\text{Value ÷ Gross Annual Income} = \text{Gross Rent Multiplier}
\]

Some questions refer to the value as the sale price and/or to the gross annual income as gross rents. Expect the question to include information, such as expenses, that will attempt to direct you to net income...ignore it! Remember to use only gross income.

Some state exams might ask for monthly income instead of annual income, which would be referenced as gross monthly rent multiplier, or GMRM. Read the question carefully to understand which timeframe is used.

For Example:

Read the questions carefully:
1. A property is valued at $195,000 and generates an annual income of $24,000. Building expenses run $1,100 per month, leading to a net income of $10,800. Calculate the gross rent multiplier.

Solve the problem:
\[
195,000 ÷ 24,000 = 8.125
\]
The GRM is 8.125.

Note: In some questions the answer might be rounded to 8.13, 8.1, or possibly 8.

2. If the GRM derived above is applied to a subject property that generates $1,800 monthly, calculate the value of the subject property.

Solve the problem:
\[
\begin{align*}
$1,800 \text{ (Monthly Income)} \times 12 \text{ (Months)} &= $21,600 \text{ (Annual Income)} \\
$21,600 \text{ (Annual Income)} \times 8.125 \text{ (GRM)} &= $175,500
\end{align*}
\]
The indicated value of the subject property is $175,500.

Sample Problems (to be worked in class)
1. A property is valued at $150,000 and generates annual income of $30,000. Building expenses run $1,500 per month, leading to a net income of $12,000. Calculate the gross rent multiplier.

2. A property generates gross rents of $40,000 yearly. It recently sold for $300,000. If it has a vacancy rate of 10% and expenses are $1,200 per month, calculate the gross rent multiplier.

3. Calculate the gross rent if a property valued at $900,000 had a GRM of 9.5.
Formula 10: Profit/Loss/Return on Investment

This type of problem will give you both the original purchase price of the property and the eventual sale price. You will be asked to calculate the return on investment (ROI) or percent of profit—both are the same figure!

A simple formula expressed as a “poem” comes in handy:

What You Made ÷ What You Paid = Percentage of Profit

or

What You Lost ÷ What It Cost = Percentage of Loss

For Example:

Read the question carefully
A parcel of land is purchased for $100,000 and later sold for $115,000. What is the percent of profit?

Solve the problem
Divide what you made by what you paid:
15,000 ÷ 100,000 = 0.15

The percent of profit is 15%.

Sample Problems (to be worked in class).

1. A man purchases land for $50,000. He divides it into three lots that are sold for $20,000 each. What is his return on investment?

2. You purchase an investment property for $125,000. You later sell it at a loss of $20,000. What is your percent of loss?

3. B sold his real estate for $234,900 and made a 28% profit. What did he originally pay for that property?
Formula 11: Seller Pricing/Net to Owner

Seller pricing and net to owner questions are one of the few types of questions where one or two words will not identify the type of question for you. You will need to read the entire question in order to recognize it.

In the problem, an owner is selling a home and you will be given a number of cost items, including brokerage commission. Your task is to determine the ultimate selling price (which may also be called “listing price,” “sale price,” or “minimum offer”):

1. Total the money the seller must get. This is the "part."
2. Divide it by the percentage of the sale that it represents. This is the "%."
3. The answer is the "whole."

For Example:

Read the question carefully:
L wants to sell her home. She must pay off her existing $35,000 mortgage and pay $3,200 in closing costs. She wants to have $40,000 left so she can buy another home. If she pays a 6.5% commission, what is the minimum offer she can accept?

Solve the problem:

\[
\text{Whole} = \frac{\text{Part}}{\%}
\]

\[
78,200 \div 0.935 (93.5\%) = 83,636.3636
\]

L must sell her house for a minimum of $83,636.36.

Sample Problems (to be worked in class)

1. J is selling her home. She needs to pay off a $65,000 first mortgage, a $15,000 second mortgage, and wants $10,000 in cash for herself. If her closing costs will total $1,200 and she must pay a 7% commission, how much must she sell the property for?

2. A family is considering an offer on their home. They must pay off a $115,000 loan, pay closing costs of $1,000, and a survey fee of $425. Their broker is charging them a 5% commission. Determine the minimum acceptable offer.
Math Exercises

1. A seller must pay off an existing $42,000 mortgage and pay $1,700 in closing costs. If the seller wants to net $22,000 after paying a brokerage fee of 7%, for how much must the home be sold?

2. An individual purchased two lots last year for $10,000 each. The lots just sold for a total of $25,000. What is the percent of profit?

3. A property is currently valued at $3,500,000. If it generates an annual income of $175,000 and annual expenses total $40,000, what is the gross rent multiplier?

4. An apartment building generates $150,000 in yearly income. Building expenses total $2,000 per month. Using a capitalization rate of 9%, what is the building's value?

5. A lot is listed for sale at $1,500 per acre. Calculate the listing price for the parcel described as the S 1/2, SE 1/4, NE 1/4 of Section 33.

6. A buyer agrees to purchase a property for $150,000. The buyer will make a cash down payment of $30,000, the seller will carry a second mortgage of $10,000, and the buyer will get a first mortgage in the amount of $110,000 from a local savings and loan. How much is the transfer tax?

7. You are going to build a building. It will be 40' x 40' and consist of two floors. If the price per square foot of the building is $90, and the cost of a 150' x 500' lot is $100 per front foot, what is the total cost of the project?

8. A property is appraised for tax purposes at $150,000 and assessed for tax purposes at 35% of value. Using a total of 95 mills, calculate the annual taxes.

9. In the previous question, the property has been sold and will close on October 15. If the taxes for the first half of the year are paid, using a calendar year, how much in prorated taxes will be due the buyer at closing?

10. A buyer is purchasing a home for $100,000 and will finance it with a VA loan. If the lender is charging three points, how much will be owed in points?

11. A property is sold and will close on September 15. The annual taxes, last paid for the previous year, are $2,436. Calculate the buyer's credit using a 365-day year.

12. A developer purchased a lot that measures 348' x 1,000'. If the land cost $5,000 per acre, what was the total cost?

13. A home is appraised at $130,000 and is insured for 80% of value. The premium for two-year coverage is $5 per thousand. The seller purchased and paid for the two-year policy on August 1. Nearly two years later, the property has been sold and will close on May 15. Calculate the seller's credit.

14. A house sold for $165,000 and the commission paid was $5,775. What was the rate of commission?

15. I paid $265,000 for her new home. She is putting 45% down, paying 3 points, and $2,650 in closing costs. How much money will she need to bring to the closing?

16. A property was listed for $150,000 and sold for 90% of the listing price. Commission was 7% and was split 50/50 between two brokerages. The listing broker then split his portion evenly with a listing salesperson. How much did the selling company get?

17. A property is valued at $125,000 and is assessed at 35% of value for tax purposes. Taxes are calculated at $5 per $100 of assessed value. Using a 365-day year, calculate the daily rate of taxes.

18. The apartments in a 12-unit apartment building rent for $475 per month. Vacancy and collection losses total 5% and monthly building expenses are $4,000. Calculate the effective gross income.
Math Quiz

1. A home is appraised at $125,000 and the assessment level is 35%. There are a total of 40 mills in the taxing area. What are the annual taxes?
   A. $1,750
   B. $1,853
   C. $2,361
   D. $3,215

2. How many acres are there in the shaded area? What is the correct description for this section?
   A. 10 acres, N 1/2, NE 1/4, SE 1/4
   B. 10 acres, N 1/2, NW 1/4, SW 1/4
   C. 20 acres, N 1/2, NW 1/4, SE 1/4
   D. 20 acres, N 1/2, NW 1/4, SW 1/4

3. Mr. and Mrs. D sold their home for $182,800 and it is due to transfer on August 13. The buyer, Miss F, took out a loan for $162,800 and is planning on moving in on August 15. Who pays the conveyance fee and how much is it?
   A. Miss F—$20
   B. Miss F—$163
   C. Mr. and Mrs. D—$182
   D. Mr. and Mrs. D—$183

4. B expects a return of 8% on his investments and is considering a property with an asking price of $670,000. The records show a potential income of $6,200 a month, expenses of $1,500 a month, and a vacancy factor of 10%. With this information in mind, what would B's highest bid be?
   A. $137,000
   B. $343,250
   C. $612,000
   D. $818,250

5. D wants to net $132,000 for his home. He has to pay off an existing mortgage of $19,700. His closing costs will run $5,400 and he owes the broker a fee of 7%. For D to get the net figure he wants, what must he sell the home for?
   A. $141,935
   B. $157,100
   C. $163,118
   D. $168,925

6. Mr. and Mrs. W want to net $90,000 when they sell their home. They have to pay closing costs of $3,200 and the broker a 6% commission. What is the least the home can sell for to net $90,000?
   A. $93,200
   B. $98,945
   C. $99,149
   D. $99,500

7. A house costs $100,000. The buyer is making a down payment of $32,000 and getting a $68,000 loan. If there are 4 points, how much money will be paid out of the closing for the points?
   A. $400
   B. $1,280
   C. $2,720
   D. $4,000

8. How many square feet are there in the S 1/2, SW 1/4, NE 1/4 of Section 28?
   A. 136,125
   B. 435,600
   C. 720,480
   D. 871,200

9. Mr. and Mrs. M sold the lot adjoining their home for $15,000. If the lot measures 300 feet by 500 feet, how much did they get per front foot?
   A. $30
   B. $50
   C. $300
   D. $500
10. A property has a gross monthly income of $12,600 and a vacancy and collection loss rate averaging 11%, with monthly expenses of $1,500 and depreciation of 6% a year. What would be the highest offer the prospective buyer should come up with if he insists on a 15% rate of return and the asking price is $850,000?

A. $723,293  
B. $730,493  
C. $777,120  
D. $833,293
Sample Problems Answer Key

**Formula 1: Percent Problems**

1. **$3,150.** The "whole" is the $90,000 selling price. The percent is actually 3.5% (half of the 7% commission). To find the commission amount, multiply the whole by the percent: $90,000 \times 0.035 = \$3,150.

2. **$75,000.** The seller paid total commission of $4,500 ($2,250 \times 2), which is the "part." To find the "whole," which is the sales price, divide the part by the percentage: $4,500 \div 0.06 = \$75,000. You could also divide the selling company's commission of $2,250 by 3%, their portion of the commission, and you would get the same answer: $2,250 \div 0.03 = \$75,000.

3. **6.5%.** The total commission paid is $10,244 ($5,122 \times 2). That is the "part" that goes at the top of the circle. The "whole" is the sales price of $157,600. To find the percent, divide the part by the whole: $10,244 \div $157,600 = 0.065, or 6.5%.

4. **80%.** First, determine the loan amount by subtracting the down payment from the sales price: $326,000 - $65,200 = $260,800. Then find the LTV by dividing the loan amount (the "part") by the sales price (the "whole"): $260,800 \div $326,000 = 0.80 or 80%. Alternatively with LTV, you could have divided the down payment (the "part") by the sales price (the "whole") to find the % of down payment: $65,200 \div $326,000 = 0.20 or 20%. If the down payment is 20%, the LTV is 80% (100% - 20% - 80%).

5. **$165,000.** If the interest paid on the loan is $550 for the month, first multiply by 12 to find the annual interest: $550 \times 12 = \$6,600. Now that you have the "part," you can divide by the percentage to find the loan balance (the "whole"): $6,600 \div 0.04 = \$165,000.

**Formula 2: Points**

1. **$1,600.** First, find the mortgage amount. The buyer is borrowing 80% of the sales price: $100,000 \times 0.80 = \$80,000. Each point is 1% of the loan amount, so each point costs $800: $80,000 \times 0.01 = \$800. Two points would cost $1,600 ($800 \times 2).

2. **$3,000.** Each point is 1% of the loan amount: $75,000 \times 0.01 = \$750. Four points will cost $3,000 ($750 \times 4).

3. **Three points.** First, determine the loan amount, which is the "whole": $125,000 \times 0.80 = \$100,000. The "part" is $3,000. To find the percent, divide the part by the whole: $3,000 \div $100,000 = 0.03 or 3%. Since each point is 1% of the loan, we know that J paid 3 points.

**Formula 3: Property Taxes**

1. **$4,200.** First, find the assessed value: $150,000 \times 0.35 = \$52,500. Find the cost of each mill by dividing the assessed value by 1,000: $52,500 \div 1,000 = 52.5. Finally, multiply the cost of each mill by total mills: 52.5 \times 80 = \$4,200.

2. **68 mills.** First, find out the cost of each mill: $35,000 \div 1,000 = \$35.00. Next, divide the taxes paid by the cost per mill: $2,380 \div \$35.00 = 68 mills.

3. **$1,662.50.** First, find the assessed value of the property: $100,000 \times 0.35 = \$35,000. Next, find the cost of each mill: $35,000 \div 1,000 = \$35.00. Finally, multiply the mill cost by the total mills: $35.00 \times 47.5 = \$1,662.50. The annual taxes are $1,662.50.

**Formula 4: Prorations**

1. **$525.00.** First, find the cost per day using a 360-day year: $1,575 \div 360 = \$4.3750. Then, determine how many days for which the seller is responsible. When using a 360-day year, each month is simply 30 days, so four months is 120 days. Finally, multiply the daily rate by the number of days: $4.3750 \times 120 = \$525.00. This is the seller's share of the taxes.

2. **$192.88.** First, find the daily rate of the taxes using a 365-day year: $2,200 \div 365 = \$6.0274. Then, determine the number of days the seller lived in the home for which the buyer will pay taxes (remember the day of sale belongs to the seller): July=31 + August=1 is 32 days. Finally, multiply the daily rate by the number of days: $6.0274 \times 32 = \$192.88$ (rounded). The buyer will be credited for $192.88 at closing.
3. $37.18. Since this is a two-year policy, first, determine the annual cost: $460 ÷ 2 = $230. Then find the daily rate: $230 ÷ 365 = 0.6301. Next, determine the number of days that the buyer will take advantage of this prepaid policy: June=28 days + July=31 days is 59 days. Finally, multiply the days by the daily rate: 59 x 0.6301 = $37.18 (rounded). The seller will be credited $37.18 at closing.

Formula 5: Lot Measurements
1. $225,000. Front feet is always the first number in a lot measurement. If the lot is $2,000, the cost is $300,000 (150 x $2,000). If that same lot were sold per square foot, first find the square footage by multiplying length x width: 150 x 600 = 90,000 square feet. At $2.50 per square foot, the lot would cost $225,000 (90,000 x $2.50 = $225,000).

2. 3 bags of concrete. This is a problem of volume. First, find the volume of the sidewalk by multiplying length x width x depth. It's important to first ensure that all measurements are the same unit. To convert 4 inches to feet, you need to divide by 12: 4 ÷ 12 = .3333. Now you can find the volume of the sidewalk in cubic feet: 60 x 4 x .3333 = 79.9920 cubic feet. Each bag of concrete makes one cubic yard. To convert cubic feet to cubic yards, you divide by 27 (there are 27 cubic feet in each cubic yard): 79.9920 ÷ 27 = 2.962 bags. You would need 3 bags of concrete for the job.

3. 4,750 square feet. One method to determine the square footage of a trapezoid-shaped property is to first average the two uneven sides, known as side opposite averaging, then multiply: 80' + 110' = 190'. Then, 190 ÷ 2 = 95'. Finally, 50' x 95' = 4,750 SF.

Formula 6: Transfer Tax
1. $150. Don't be distracted by extra information in the question. First determine the number of taxing units: $149,900 ÷ 1,000 = 149.9. Round up to 150 to account for the fraction thereof. Then determine the transfer tax by multiplying the number of taxing units by the transfer tax of $1.00 per $1,000 of transaction value, or fraction thereof: 150 x $1 = $150. The seller owes $150 in transfer taxes.

2. $148. $147,500 ÷ 1,000 = 147.5 or 148 taxing units. Next, 148 x $1 = $148 in transfer tax owed by the seller.

Formula 7: Sections
1. This is the NE 1/4 of the NE 1/4.

2. 90 acres. There are two parcels. The first is N 1/2, NW 1/4: 640 ÷ 2 ÷ 4 = 80 acres. The second parcel is SW 1/4, NW 1/4, NE 1/4: 640 ÷ 4 ÷ 4 ÷ 4 = 10 acres. Add them together to find the total acreage: 80 + 10 = 90 acres.

3. $37,800. First, find the acreage: 640 ÷ 2 ÷ 4 ÷ 4 = 20 acres. Then determine the price: 20 x $31,500/acre = $630,000. Finally, find the commission on the sale: $630,000 x 0.06 = $37,800.

Formula 8: Capitalization
1. $250,000. First, you need to find the net operating income (NOI). This is found by subtracting the operating expenses ($2,500 x 12 = $30,000) from the annual income. Debt service and depreciation do NOT figure into the NOI calculation. So, $50,000 - $30,000 = $20,000 NOI. Then, divide the "part," which is income, by the cap rate of 8%: $20,000 ÷ 0.08 = $250,000. The building value using the 8% cap rate is $250,000.

2. $653,333.33. First, you need to find the net operating income. The potential gross income is $6,000 per month (10 units at $600 each), which is $72,000 per year. Next, you need to subtract the 10% vacancy loss: $72,000 - 10% = $64,800. Next, subtract building expenses of $6,000 ($500 x 12) to get to the NOI: $64,800 - $6,000 = $58,800. Remember that depreciation is NOT part of the NOI calculation. Once you have the NOI, divide by the 9% cap rate to find the value: $58,800 ÷ 0.09 = $653,333.33. The investor would be willing to pay $653,333.33 to buy this building.
Formula 9: GRM
1. **GRM=5.** The gross rent multiplier does not take expenses into consideration, only the gross income. To find the GRM, simply divide the value by the gross income: \$150,000 ÷ \$30,000 = 5
2. **GRM=7.5.** To find the gross rent multiplier, divide the value by gross income: \$300,000 ÷ \$40,000 = 7.5. Vacancy rate and expenses are not part of the GRM calculation.
3. **\$94,736.84.** When using the gross rent multiplier, you can determine the gross rent (income) by dividing the value (sales price) by the stated GRM: \$900,000 ÷ 9.5 = \$94,736.84.

Formula 10: Profit/Loss/ROI
1. **20% profit.** The property sold for $60,000 (2 x $20,000), which is $10,000 more than what he paid. To find the return on investment (ROI), remember to divide what was made by what was paid: $10,000 ÷ $50,000 = 20%. The man’s profit is 20%.
2. **16% loss.** When determining the percent of a loss, remember to divide what you lose by what it cost: $20,000 ÷ $125,000 = 16%. Your loss percent is 16%.
3. **$183,515.62.** When you know the percent of profit and want to find the original purchase price, you need to first add the profit percent (28%) to the percent of the original price (100%). Then, divide selling price by 128%: $234,900 ÷ 1.28 = $183,515.62. Bill originally bought the property for $183,515.62, and he made a profit of $51,384.38 ($234,900 - $183,515.62).

Formula 11: Seller Pricing/Net to Owner
1. **$98,064.52.** First, determine how much she needs to cover her costs and desired cash: \$65,000 + \$15,000 + \$10,000 + \$1,200 = $91,200. Since she's paying a 7% commission, next divide the costs by 93% (100% - 7%) to find the minimum selling price: \$91,200 ÷ 0.93 = $98,064.52.
2. **$122,552.63.** First, figure the costs: $115,000 + $1,000 + $425 = $116,425. Since the commission rate is 5%, now divide the costs by 95% (100% - 5%) to find the minimum acceptable: $116,425 ÷ 0.95 = $122,552.63.

Math Exercises Answer Key
1. Add the required costs to the desired net (excluding commission): $42,000 + $1,700 + $22,000 = $65,700. This is 93% of the total amount he needs to net (100% - 7% commission). Divide amount by 93% to find the minimum selling price: $65,700 ÷ 0.93 = $70,645.16
2. Original purchase price is $20,000. Total profit is $5,000 ($25,000 - $20,000). Divide profit (what was made) by original price (what was paid) to find the percent of profit: $5,000 ÷ $20,000 = 0.25 or 25%
3. Expenses do not factor into the GRM. Simply divide the value by annual gross income: \$3,500,000 ÷ $175,000 = 20 GRM
4. Subtract annual expenses ($2,000 x 12 months = $24,000) from annual income to find the net operating income: $150,000 - $24,000 = $126,000. Divide NOI by the cap rate to find value: $126,000 ÷ 0.09 = $1,400,000
5. Find the acreage: 640 ÷ 4 ÷ 4 ÷ 2 = 20 acres. The lot sold for $30,000 ($1,500 x 20).
6. Transfer tax is based on the sales price, which is $150,000. For these exercises, we’re assuming the transfer tax is $1 per $1,000, so $150
7. First, determine the square footage: 40’ x 40’ = 1,600 square feet per floor, for a total of 3,200 SF. The price per square foot is $90: 3,200 SF x $90 = $288,000 for the building. The lot has 150 front feet (always the first number), which cost $100 per front foot: 150’ x $100 = $15,000. Add the cost of the building and the lot: $288,000 + $15,000 = $303,000
8. Find the assessed value: $150,000 x 0.35 = $52,500. Multiply by 95 mills (or 0.095) to find the annual taxes: $52,500 x 0.095 = $4,987.50
9. The annual taxes are $4,987.50, so the daily rate is $13.6644 (4,987.50 ÷ 365). The semiannual taxes are $2,493.75 (4,987.50 ÷ 2). Taxes are paid in arrears, so the seller owes the buyer for the days he lived in the house: July-31 days + August-31 days + September-30 days + October-15 days = 107 days. Multiply that by the daily rate: 107 x $13.664383 = $1,462.09 credit to the seller and debit to the buyer.

10. One point equals 1% of the loan. A veteran can get a loan from the VA with no downpayment, so each point will cost the borrower $1,000. Three points, then, will cost the borrower $3,000 ($1,000 x 0.01 x 3).

11. The annual taxes are $2,436, so the daily rate is $6.6740 (2,436 ÷ 365). Taxes are paid in arrears, so the seller owes the buyer for the days she lived in the house: January-31 days + February-28 days + March-31 days + April-30 days + May-31 days + June-30 days + July-31 days + August-31 days + September-15 days = 258 days. Multiply that by the daily rate: 258 x $6.6740 = $1,721.89 credit to the seller and debit to the buyer.

12. First, determine the lot size: 348 x 1,000 = 348,000 square feet. Divide by 43,560 to find the acreage: 348,000 ÷ 43,560 = 7.9889 acres. Total cost of the lot is $39,945 (rounded): 7.9889 x $5,000 = $39,944.90

13. Calculate the insured value: $130,000 x 0.80 = $104,000. At $5 per thousand, the premium is $520. To find the daily cost, divide by 730 days (2 years): $520 ÷ 730 = $0.7123 per day. Determine the days the seller paid for the policy but did not live in the house, which would be the time the buyer lived in the house: May-16 days + June-30 days + July-31 days = 77 days. Multiply by the daily rate to find the seller’s credit: $0.7123 x 77 = $54.85

14. Divide the commission paid by the sales price: $5,775 ÷ $165,000 = 0.035, or 3.5%.

15. First, calculate the down payment: $265,000 x 0.45 = $119,250. Each point is 1% of the loan amount, which is $145,750 ($265,000 - $119,250). So, one point is $1,450.75. Three points will cost her $4,372.50 ($1,450.75 x 3). Add in the closing costs to find the total amount she must bring to closing: $119,250 (down payment) + $4,372.50 (3 points) + $2,650 (closing costs) = $126,272.50

16. First, determine the sales price: $150,000 x 0.90 = $135,000. The selling broker got half of the 7% commission, so 3.5% commission: $135,000 x 0.035 = $4,725

17. First, find the assessed value: $125,000 x 0.35 = $43,750. Next, find the annual taxes: $43,750 x 0.05 = $2,187.50 ($5 per $100 = 0.05). Divide taxes by 365 to find the daily rate: $2,187.50 ÷ 365 = $5.99

18. First, find the potential gross income: $475 x 12 units x 12 months = $68,400. Find vacancy and collection losses: $68,400 x 0.05 = $3,420. Subtract that to find the effective gross income: $68,400 - $3,420 = $64,980. EGI does not consider expenses. If you subtract that, you will find the net operating income.
**Math Quiz Answer Key**

1. **A.** Find the assessed value: $125,000 \times 0.35 = \$43,750$. Multiply the assessed value by 40 mills (or 0.040): $\$43,750 \times 0.040 = \$1,750$ in annual taxes.

2. **C.** This is the N 1/2, NW 1/4, SE 1/4. A section is 640 acres, so starting from left to right: $640 \div 4 \div 4 \div 2 = 20$ acres.

3. **D.** The transfer tax, or conveyance fee, is usually paid by the seller. For these examples, we've been using $1$ per $1,000 of sales price or fraction thereof. $\$182,800 \div 1,000 = 182.8$ or 183 taxing units. $183 \times \$1 = \$183$ owed by the sellers.

4. **C.** Find the NOI: $\$6,200 \times 12$ months = $\$74,400$ annual potential gross income. Subtract 10% for vacancy/collection losses to find the effective gross income: $\$74,400 - \$7,440 = \$69,960$. $\$1,500 \times 12$ months = $\$18,000$ annual expenses. Subtract that from EGI to find the net operating income: $\$69,960 - \$18,000 = \$48,960$. Divide NOI by the cap rate of 8% to find the price B is willing to offer: $\$48,960 \div 0.08 = \$612,000$.

5. **D.** Add the required costs to the desired net (excluding commission): $\$132,000 + $19,700 + $5,400 = \$157,100$. This is 93% of the total amount he needs to net (100% - 7% commission). Divide amount by 93% to find the minimum selling price: $\$157,100 \div 0.93 = \$168,925$.

6. **C.** Add the desired net and costs: $\$90,000 + $3,200 = \$93,200$. Divide that by 94% (100% - 6% commission): $\$93,200 \div 0.94 = \$99,149$.

7. **C.** Points are paid on the loan amount. One point = 1%. If the loan amount is $\$68,000$, each point costs $\$680$. Four points, therefore, is $\$2,720 (\$680 \times 4)$.

8. **D.** First, determine the acreage of the parcel: $640 \div 4 \div 4 \div 2 = 20$ acres. Each acre is 43,560 square feet. Multiply to find the square footage of the parcel: $20 \times 43,560 = 871,200$ SF.

9. **B.** When discussing dimensions, front feet is always the first number, so 300 feet. Divide the sales price by the frontage to find the price per front foot: $\$15,000 \div 300 = \$50/ front foot$.

10. **C.** Find the NOI: $\$12,600 \times 12$ months = $\$151,200$ annual potential gross income. Subtract 11% for vacancy/collection losses to find the effective gross income: $\$151,200 - \$16,632 = \$134,568$. $\$1,500 \times 12$ months = $\$18,000$ annual expenses. Subtract that from EGI to find the net operating income: $\$134,568 - \$18,000 = \$116,568$. Divide NOI by the cap rate of 15% to find the price the buyer is willing to offer: $\$116,568 \div 0.15 = \$777,120$.
Real Estate Math Formulas

Potential Gross Income (PGI)
- Vacancy/Collection Loss
+ Miscellaneous Income

Effective Gross Income (EGI)
- Operating Expenses

Net Operating Income (NOI)
- Debt Service (principal+interest)

Cash Flow (before taxes)

Cash Flow

Cash Investment = Cash-on-Cash Return
Practice Exam
1. A woman purchased a home on a lake. A boat was included in the sale. What is most likely required at settlement to transfer ownership of that boat to her?
   A. bill of sale  
   B. deed  
   C. purchase agreement  
   D. sales contract

2. F signs an exclusive right to sell listing agreement with broker R. Before the listing expires, F terminates the agreement for no reason. The following day, F sells the property to a co-worker. Which statement is TRUE?
   A. R can sue F to recover only the marketing expenses.  
   B. R can sue F for the full commission based on the list price.  
   C. R can sue F for the full commission based on the sales price.  
   D. R has no right to sue F, since a seller can terminate a listing at any time without cause.

3. Which statement about lead paint is FALSE?
   A. Issues arise when lead-based paint begins to chip or flake. 
   B. Lead paint disclosure must be made when selling a house built prior to 1982. 
   C. Lead poisoning occurs via the nose and mouth; it must be breathed in or ingested. 
   D. Lead present in water is colorless, odorless, and tasteless.

4. A developer purchases a foreclosed property for $96,000, intending to rehab it. Instead, he lets it deteriorate and finally sells it a few years later for $84,000. Calculate his loss.
   A. 8.75%  
   B. 11.4%  
   C. 12.5%  
   D. 14.2%

5. A homeowner lists her property at $155,000. Her broker receives an offer from A for $135,000 cash and a closing in 30 days; another offer from B for $145,000, subject to the owner taking back a purchase money mortgage; and an offer from C at $150,000, subject to the buyer obtaining a mortgage. What should the listing broker do?
   A. Present all of the offers to the seller, even if the seller accepts the first offer.  
   B. Present none of the offers, as they are all below the seller’s asking price.  
   C. Present only the first offer until the seller makes a decision; then present the next offer.  
   D. Present whichever offer is the highest and has the most favorable terms for the seller.

6. K is a transfer student from Korea looking for a one-bedroom apartment. She asks for something near the university. Her rental agent L shows her apartments only in an area known as Chinatown, telling her she’d feel more at home there. L could be guilty of
   A. blockbusting. 
   B. panic peddling. 
   C. redlining. 
   D. steering.

7. A lender must provide the Closing Disclosure to a borrower at least __________ prior to settlement.
   A. 1 business day  
   B. 3 business days  
   C. 3 calendar days  
   D. 5 business days

8. An investor is evaluating the performance of his duplex. If he subtracts debt service from the net operating income, what does he find?
   A. cash flow before taxes  
   B. cash-on-cash return  
   C. effective gross income  
   D. reserves for replacement

9. Market value can be defined as the
   A. amount a buyer paid to purchase a property.  
   B. cost in materials and labor necessary to construct property.  
   C. most probable selling price in a typical transaction.  
   D. what a property actually sold for.
10. A real estate licensee has actual knowledge of structural damage to the floor boards of a home he has listed due to termite infestation. He informs the buyer’s agent that there are no termites or termite damage in the home. The buyer signs a contract to purchase the property. Is the listing agent susceptible to claims of fraud?
   A. No, because the buyer should have discovered the termite damage.
   B. No, because the buyer’s agent should have been looking out for the buyer.
   C. Not as long as there is an as-is clause in the purchase agreement.
   D. Yes, because he intentionally withheld a material defect.

11. A buyer offers a seller $189,500 for his house. The seller accepts. The appraisal comes in at $188,000. If the buyer’s lender requires a loan-to-value ratio of 80%, how much of a down payment must she make?
   A. $37,600
   B. $37,900
   C. $39,100
   D. $39,500

12. Legally, the presence of a sexual offender in the neighborhood is considered
   A. confidential information that a licensee cannot disclose.
   B. an immaterial fact that a licensee is not required to disclose.
   C. a material fact that a licensee must disclose.
   D. a material fact that the seller must disclose.

13. An investor paid $330,000 for a small strip mall, plus $20,000 in closing costs. The land on which it sits is valued at 45%. What is the total amount that he will be able to deduct next year as depreciation (rounded)?
   A. $3,808
   B. $4,038
   C. $4,654
   D. $4,936

14. Which obligation has first priority in the event of a foreclosure sale?
   A. ad valorem taxes
   B. first mortgage
   C. IRS tax lien
   D. mechanic’s lien

15. Abandoned private property redeemed by the local government is an example of
   A. eminent domain.
   B. escheat.
   C. police power.
   D. taxation.

16. Which situation represents a blind ad?
   A. A broker includes the NAR logo on his business card, but he is not a REALTOR®.
   B. A broker includes a national franchise logo in an ad, but she has no affiliation with it.
   C. A homeowner is selling her house FSBO but puts a local broker’s name on the yard sign.
   D. A licensee places a for sale sign in his client’s yard with only his phone number on it.

17. Which statement about FHA-insured loans is TRUE?
   A. FHA loans are targeted to low-income borrowers.
   B. FHA loans require a smaller down payment than conventional loans.
   C. FHA provides funds directly to borrowers.
   D. Only first-time homebuyers can qualify for an FHA loan.

18. A subject property has 4 bedrooms; a comparable property has 3. A bedroom in that neighborhood is valued at $5,000. The comp does not have a basement; the subject does. The basement is valued at $8,000. The comp has a pool; the subject does not. A pool is valued at $4,000. The comp sold for $260,000. What is the subject’s estimate of value based on this comp?
   A. $247,000
   B. $264,000
   C. $269,000
   D. $273,000
19. A dual agent who represents both buyer and seller in the same transaction CANNOT
   A. estimate the closing costs that each should expect to pay.
   B. make arrangements to gather documentation in preparation for settlement.
   C. recommend an amount to offer or counteroffer.
   D. perform a comparative market analysis of similar properties and present it to both.

20. A woman with a disability applies to rent a single-family house. She states that she needs to install grab bars in the shower and a ramp into the house from the garage. The landlord would violate federal fair housing laws if he
   A. insists pay the woman make the renovations and remove them when her lease is up.
   B. makes the renovations at his own expense.
   C. makes the renovations but requires the woman to pay for the materials and labor.
   D. refuses to allow the woman to make the renovations.

21. A is buying B’s house. A and B, their attorneys, and the settlement officer attend the closing where title is of the house is transferred to A. What must occur to provide constructive notice of A’s ownership?
   A. The attorneys must sign an affidavit attesting to the fact.
   B. The new deed must be recorded in the public records.
   C. The settlement officer must file the new title with the county clerk.
   D. Nothing; those attending the closing already have constructive notice.

22. For which property would the comparable sales approach be LEAST useful?
   A. multi-family residential property
   B. retail property
   C. single-family residential property
   D. special purpose property

23. Buyer and seller have agreed to terms and signed a purchase agreement. Prior to settlement, the buyer has
   A. escrowed title to the property.
   B. equitable title to the property.
   C. legal title to the property.
   D. no legal claim on the property.

24. RESPA applies to ___________ financed by a federally regulated loan.
   A. any commercial or residential property
   B. any residential property
   C. one- to four-family residences
   D. only single-family dwellings

25. ABC Corporation purchases land on which it builds new office building. How does ABC own that land?
   A. corporate tenancy
   B. tenancy by the entirety
   C. tenancy in common
   D. tenancy in severalty

26. A seller needs to pay an estimated $3,500 in closing costs, $96,000 on her current mortgage, and wants $45,000 in cash for a down payment on another house. Her listing agreement obligates her to pay 6.5% commission to the brokerage. What is the minimum selling price she can accept? Round your answer up to the nearest dollar.
   A. $148,835
   B. $153,893
   C. $154,546
   D. $158,509

27. The state has decided to widen the highway in front of J’s home. It will be necessary to use 15 feet of his front yard to do so. The taking of J’s land by the state is the act of
   A. condemnation.
   B. confiscation.
   C. eminent domain.
   D. right-of-way.
28. Agent S executes a buyer agency agreement with buyer B. S reads an ad placed by a FSBO seller, offering 3.5% commission to the broker who brings the buyer. What is the seller’s relationship to S if B makes an offer on the house?
A. The seller is an agent.
B. The seller is a client.
C. The seller is a customer.
D. The seller is a principal.

29. A property owner wants to put in a wheelchair ramp to accommodate a disabled family member. The ramp’s proximity to the sidewalk would violate the setback requirements for the community. What should the property owner request of the zoning commission?
A. a grandfather clause
B. a nonconforming use
C. a spot zone exception
D. a variance

30. A parcel of ground described as the N 1/2, SE 1/4 of a section sells for $5,000 per acre. If the commission is 7% and it is split 50/50 between two brokerage companies, how much did each company receive?
A. $7,000
B. $11,200
C. $14,000
D. $28,000

31. Which would LEAST LIKELY be considered functional obsolescence?
A. home with crumbling roof
B. home with low ceilings
C. home with steep, narrow stairs
D. geodesic dome home in neighborhood of ranches

32. A homeowner enters into a listing agreement with a brokerage company. Several days into the listing, but before the broker begins actively marketing the property, the homeowner sells the property to a close friend. If the homeowner stills owes the broker a commission, what type of listing was it?
A. exclusive listing
B. exclusive right to sell listing
C. net listing
D. open listing

33. A nursery and tree farm has been operating just outside of the city limits for 30 years. Over time, the area around the nursery is rezoned from agricultural to residential as the farmland is subdivided. What type of zoning exception would allow the nursery and tree farm to continue operation?
A. area variance
B. conditional use
C. nonconforming use
D. special exception

34. A home sells for $327,650. If the state transfer tax is 50 cents per $500 of value or fraction thereof, what will the seller owe the state in transfer tax at closing?
A. $327.65
B. $328.00
C. $490.50
D. $492.00

35. Which actions, if taken by the Federal Reserve Board, would MOST LIKELY cause an increase in interest rates?
A. decrease the reserve requirement, increase the discount rate, buy government securities
B. decrease the reserve requirement, decrease the discount rate, sell government securities
C. increase the reserve requirement, increase the discount rate, buy government securities
D. increase the reserve requirement, increase the discount rate, sell government securities

36. A small strip mall has an effective gross income of $44,000. Operating expenses are $26,000, and debt service is $8,800. If the desired capitalization rate is 10%, how much would a buyer be willing to pay for the property?
A. $32,400
B. $92,000
C. $172,000
D. $180,000
37. A licensed real estate broker takes a seller’s listing, but later decides he wants to buy the property himself. He can purchase the property for himself
   A. if he gets someone else to represent the seller.
   B. if he discloses to the seller that he is the buyer.
   C. only after the listing agreement expires.
   D. never; a licensee cannot purchase one of his own listings.

38. A and B sign a purchase agreement. Prior to closing, it is discovered that A was legally incompetent when she signed the contract. What is the status of the contract?
   A. executory
   B. valid, unless there was fraud
   C. void
   D. voidable by A only

39. The idea that an informed buyer will pay no more for a property than the cost of acquiring another equally desirable property with equal utility is based upon the principle of
   A. conformity.
   B. highest and best use.
   C. increasing and decreasing returns.
   D. substitution.

40. An investor owns a small commercial building that he rents to a chef, who installs a pizza oven and opens a restaurant. Four years later, the owner sells the property to a different chef, who wants to start his own restaurant. When the tenant’s lease is up, who owns the pizza oven?
   A. the new owner, since the oven is an improvement that transfers with ownership
   B. the original owner, since the oven was attached when he owned the property
   C. the tenant who installed the pizza oven
   D. It’s impossible to tell without more information.

41. In an advertisement for a home, which of the following statements would MOST LIKELY be considered discriminatory?
   A. “beautiful home in an exclusive neighborhood”
   B. “cozy home with a fabulous view of the bay”
   C. “excellent location; lots of amenities; near bus stop”
   D. “four-bedroom charmer, fenced lot, on a quiet cul-de-sac”

42. Local governments exercise control over the permitted use of private property primarily through
   A. building codes.
   B. covenants, conditions, and restrictions (CCRs).
   C. deed restrictions.
   D. zoning ordinances.

43. Which element of an adjustable rate mortgage determines whether the interest rate goes up or down?
   A. cap
   B. index
   C. margin
   D. rate

44. A man signs a one-year lease on a high-rise apartment. Six months into the lease, he is transferred out of state. He signs over the remaining six months of his lease to a co-worker. She pays the property manager directly, relieving the original lessee of primary liability. This is an example of
   A. assignment.
   B. novation.
   C. sublease.
   D. surrender.

45. A brokerage practices designated agency. A licensee brings in a listing for a seller’s house. The seller then asks that same licensee to represent her in her search to find a new house, signing a buyer agency agreement with the brokerage. This makes the licensee a
   A. designated buyer’s agent only.
   B. designated seller’s agent only.
   C. designated seller’s agent and designated buyer’s agent.
   D. dual agent.
46. A homeowner makes up posters advertising his house for sale. He posts them on telephone poles around the neighborhood. On the poster, he indicates that he will pay 2% of the sales price to any broker who brings the buyer. What type of listing might this be considered?
A. exclusive agency  
B. exclusive right to sell  
C. net listing  
D. open listing

47. A borrower's stable monthly income is $4,200. She has three monthly debts: $350 car payment, $120 student loan payment, and $80 credit card payment. What is the maximum monthly mortgage payment she would qualify for on a conventional loan?
A. $962  
B. $1,042  
C. $1,176  
D. $1,512

48. Which statement about a comparative market analysis is FALSE?
A. A CMA can assist a buyer in determining a fair price to offer for a home.  
B. A CMA can assist a seller in determining an appropriate listing price.  
C. A CMA may be used to determine property value for a federally regulated loan.  
D. A CMA should evaluate properties currently listed, recently sold, or with expired listings.

49. When an appraiser gets a new appraisal assignment, her first task is to
A. adjust comparable sales.  
B. define the problem.  
C. gather data.  
D. reconcile the value.

50. What clause gives a lender the right to declare the entire loan balance due immediately because of borrower default or for violation of other contract provisions?
A. acceleration clause  
B. alienation clause  
C. defeasance clause  
D. prepayment clause

51. Which statement about title insurance is FALSE?
A. Coverage of an owner's policy runs for as long as the policyholder owns the property.  
B. A lender's title insurance policy is known as a mortgagee policy.  
C. Standard title insurance covers hidden risks in title such as an error in a legal description.  
D. Title insurance covers the policyholder against a future event.

52. An appraiser is evaluating a 1,200-square foot log cabin, whose owner is refinancing. He determines that the cost to replace the building would be $80 per square foot. He estimates the depreciation of the cabin to be 20% and the value of the land to be $48,000. What is his estimate of value?
A. $115,200  
B. $124,800  
C. $148,800  
D. $163,200

53. Before he put his house on the market, the seller installed paneling in the basement to cover up water damage. Under common law, this would be considered what kind of defect, and is the seller obligated to disclose it?
A. This is a latent defect that he must disclose.  
B. This is a latent defect that he is not required to disclose.  
C. This is a patent defect that he must disclose.  
D. This is a patent defect that he is not required to disclose.

54. Which home suffers from external obsolescence?
A. Home A allows access to a back bedroom only from the adjoining bedroom.  
B. Home B has only a detached one-car garage in a neighborhood of three-car garages.  
C. Home C has a foundation that is cracking and allowing water into the basement.  
D. Home D is less than 500 yards from the nuclear power plant.

55. A material made with asbestos fibers is MOST dangerous when it is
A. encapsulated.  
B. friable.  
C. heated.  
D. wet.
56. A property has gross annual income of $25,000, monthly expenses of $800, and recently sold for $200,000. What is the gross rent multiplier?
A. 8
B. 12.5
C. 12.5%
D. 12.9%

57. A buyer’s agent submits a signed offer to purchase to a listing agent, indicating a price of $200,000 and a closing within 30 days. The seller accepts the price, changes the closing to 60 days, initials the change, and signs the offer. The listing agent gives it to the buyer’s agent, who delivers it to the buyer. Is this a valid contract?
A. Yes; it is in writing and signed by both parties
B. Yes; the seller initialed his changes.
C. Yes; they agreed on the price.
D. No; there was no meeting of the minds.

58. A deed contains the following property description: “Beginning at the northeast corner of Oak and Elm streets, thence 15 degrees East to the embedded steel pin, thence North 90 degrees …” What type of legal description system is this?
A. government survey
B. lot and block
C. metes and bounds
D. plat map

59. A homeowner lists his property through a licensee of ABC Realty. The brokerage charges 6.5% commission and offers a 40% split to a cooperating broker. The licensee gets 45% of what ABC earns. The house sells for $462,000. How much does the licensee make (round to the nearest dollar)?
A. $8,108
B. $8,316
C. $9,910
D. $12,012

60. What condition is required to claim title to land through adverse possession?
A. The possessor must cultivate annual crops.
B. The possession is hostile and continual.
C. The possessor must pay consideration to the property owner.
D. The property is possessed with the owner’s knowledge and consent.

61. Which best describes the process of judicial foreclosure?
A. After advertising, a public auction of the property is held, and then the sale is confirmed.
B. Debtors lose the property by mutual agreement and return it voluntarily before final court action.
C. Debtors proactively deal with a personal financial situation that has become unmanageable.
D. Lenders forfeit all interest charged past, present, and future to the borrower in exchange for the property.

62. When the borrower repays a loan according to the terms in the note, what clause protects his rights to the property, making the mortgage null and void?
A. cognovit
B. defeasance
C. habendum
D. subordination

63. A single woman buys a home. Several years later, she gets married and changes her name. Now she wants to sell the property. To clear the cloud on the title caused by having a different name on the deed used to convey the property to someone else, she can file a
A. bar gain and sale deed.
B. limit ed warranty deed.
C. quit claim deed.
D. referee's deed.

64. The primary value of leverage to an investor is that is allows her to
A. avoid paying federal income tax.
B. control the expenses on her property.
C. get an accurate estimate of income.
D. increase her profit by using borrowed money.
65. Which of these phrases would LEAST LIKELY be evidence of conspiracy to commit an antitrust violation if said by a licensee?
A. “Every brokerage in town charges a standard 7% commission.”
B. “Our brokerage won’t work with them because they discount all of their services.”
C. “We would like to suggest that you use our attorney for the closing.”
D. “Why don’t you handle the business on the west side of town and leave the east side to our brokerage?”

66. What is the purpose of requiring mortgagors to make payments into an escrow account?
A. allow the borrower to obtain actual cash from the equity built up in the property
B. ensure that hazard insurance and property taxes on the property are paid
C. ensure the lender collects the additional interest on an adjustable rate loan
D. provide a cushion for the borrower in the event of a job loss

67. A management agreement creates an agency relationship between a real estate broker and a(n)
A. affiliated licensee.
B. buyer.
C. home seller.
D. owner of investment property.

68. R wants to call D, a previous client, to see if she’s interested in retaining him for additional services. According to the established business relationship exemption in the Do Not Call Registry, R can call her ____________ from the time of their last business transaction.
A. for up to 3 months
B. for up to 6 months.
C. for up to 18 months
D. R cannot call her at all if she’s on the Do Not Call list.

69. Which federal law prohibits discrimination against borrowers whose source of income is public assistance?
A. Equal Credit Opportunity Act (ECOA)
B. Fair Housing Act
C. Real Estate Settlement Procedures Act (RESPA)
D. Truth in Lending Act (TILA)

70. A shopkeeper pays $1,200 in rent every month for her storefront. At the end of the year, the property owner evaluates her sales records to determine whether she owes any overage rent. What type of lease does she have?
A. graduated lease
B. gross lease
C. net-net lease
D. percentage lease

71. It is a violation of the federal Fair Housing Act to exclude potential tenants because of
A. criminal history.
B. having children.
C. poor credit history.
D. possession of pets.

72. A mortgage that is used to also finance personal property such as furniture or vehicles is called a
A. blanket mortgage.
B. package mortgage.
C. purchase money mortgage.
D. wraparound mortgage.

73. Of these, which is LEAST LIKELY to be negotiable in a listing agreement?
A. the broker’s cooperation with other brokers
B. the commission to be paid to the listing broker
C. whether or not there is an end date to the listing
D. the scope of advertising and other marketing activities

74. A brokerage company represents the buyer in a cooperative transaction. The brokerage company is informed that the buyer’s earnest money deposit check has been returned for insufficient funds. What is the brokerage company’s responsibility?
A. ask the buyer if it is okay to disclose the problem
B. disclose the information to the listing brokerage immediately
C. give the buyer reasonable time to resolve the problem
D. maintain confidentiality of the client’s information
75. A man is buying a house for $240,000. He makes a down payment of $48,000. If he pays three discount points, what is the total cost of the points?
   A. $3,000  
   B. $3,840  
   C. $5,760  
   D. $7,200

76. A property owner decides to deed 10 acres of the family farm to a cousin. In the deed, he indicates that no more than one single-family home can ever be built on the property. What type of estate has the property owner created?
   A. fee simple absolute estate  
   B. fee simple defeasible estate  
   C. leasehold estate  
   D. life estate pur autre vie

77. Which statement about general warranty deeds is TRUE?
   A. They are used most often to cure defects in title.  
   B. They are used to transfer property after a foreclosure sale.  
   C. They ensure that there are no encumbrances.  
   D. They state the grantor will defend against all lawful claims.

78. A woman has a one-year lease in single-family home. Six months into the lease, the property owner dies. Which statement is TRUE?
   A. The property owner’s heirs must ask the county sheriff to remove the tenant from the premises at the end of the month.  
   B. The property owner’s heirs must honor the lease and let the tenant stay another six months.  
   C. The property owner’s heirs must post a notice on the door of the house giving the tenant 30 days to vacate.  
   D. The tenant can move out at the end of the month without penalty.

79. A triangular lot has 380 feet of frontage and is 410 feet deep. What is the acreage of this lot?
   A. .89 acres  
   B. 1.67 acres  
   C. 1.78 acres  
   D. 3.57 acres

80. How long must a licensee keep confidential information obtained from the client?
   A. Licensees have no duty to keep information confidential.  
   B. Licensees must maintain confidentiality for three years after the transaction closes.  
   C. Licensees must maintain confidentiality only until the relationship ends.  
   D. This duty never ends, even when the relationship does.

81. Y buys a house from H, who still owes $40,000 on her loan. H is NOT released from liability for that loan if
   A. Y assumes the mortgage.  
   B. Y buys the property subject to the mortgage.  
   C. the lender has begun foreclosure proceedings.  
   D. the lender agrees to a novation.

82. A woman is transferred out of state for her job and does not have time to sell her house. She signs a document granting her sister the authority only to list her house and negotiate with prospective buyers. The sister would most likely be considered what type of agent?
   A. general agent  
   B. implied agent  
   C. special agent  
   D. universal agent

83. A homeowner wants to install a laminate floor in her cottage kitchen. The room measures 12' x 18', and the flooring will cost $18.50 per square yard. How much will the materials cost?
   A. $444  
   B. $1,332  
   C. $1,998  
   D. $3,996

84. What would be the expected impact on the housing market of a large influx of people into a community?
   A. It would be impossible to predict.  
   B. It would likely result in a buyer’s market.  
   C. It would likely result in a seller’s market.  
   D. It would not affect the market
85. J, K, and L co-own a property as joint tenants. J and K are killed in a car accident. What is L's interest in the property?
A. L is a joint tenant with 100% interest.
B. L owns the property in severalty.
C. L still owns 33%, and the rest is split between the J and K's heirs.
D. The estate ends at the death of the majority of the co-owners.

86. As the net operating income of a rental property increases, what happens to the value of that property?
A. It decreases.
B. It fluctuates.
C. It increases.
D. It stabilizes.

87. Which of these is LEAST LIKELY to be a ministerial act when performed by a licensee for a buyer customer?
A. Advise a buyer on an appropriate offer price
B. Complete factual information for a buyer on a purchase offer
C. Provide a buyer with a list of home inspectors
D. Respond to questions about a property at an open house

88. Which of these tenancies could describe a landlord-tenant relationship?
A. entirety
B. freehold
C. periodic
D. severalty

89. To the owner of the land it runs across, an easement is considered an
A. attachment.
B. encroachment.
C. encumbrance.
D. trespass.

90. A borrower takes out a home equity loan for $50,000. This is a fixed rate loan with an interest rate of 12%. The borrower makes monthly payments of $514.31. What is the balance of the loan after TWO monthly payments?
A. $49,985.69
B. $49,971.24
C. $49,956.64
D. $49,941.90

91. Which buildings would NOT be exempt under Title III of the American with Disabilities Act?
A. government buildings
B. historical buildings
C. places of worship
D. private clubs

92. The sale of a property will close on March 20. Property taxes are $3,450 per year and are paid in arrears. How will this be reconciled on the settlement statement, assuming a 365-day year?
A. $746.71 Debit Seller / $746.71 Credit Buyer
B. $746.71 Credit Seller / $746.71 Debit Buyer
C. $2,703.29 Debit Seller / $746.71 Credit Buyer
D. $746.71 Debit Seller / $2,703.29 Credit Buyer

93. An option to purchase is considered binding on which party to the contract?
A. buyer only
B. seller only
C. both buyer and seller
D. neither buyer nor seller

94. A woman gets a deed of trust from a bank to finance the purchase of a house in a new subdivision. While the loan is outstanding, who holds the title to her property?
A. the bank
B. the borrower
C. the developer
D. the trustee

95. Which statement about an oral lease is TRUE?
A. An oral lease is enforceable only for commercial property, not residential property.
B. An oral lease is enforceable only if it renews an earlier, written lease.
C. An oral lease for less than one year is generally enforceable.
D. An oral lease is never enforceable.

96. What did the Supreme Court of the United States rule in the case of Jones v. Alfred H. Mayer?
A. The doctrine of “separate but equal” is unconstitutional.
B. Non-citizens have equal rights to own property.
C. Persons with disabilities are a protected class.
D. Race is a protected class with no exceptions.
97. Which situation is LEAST LIKELY to terminate a relationship between a brokerage and a homeowner who is selling his house?
   A. the broker loses her license
   B. the designated listing agent dies
   C. the homeowner declares bankruptcy
   D. the property burns down

98. A resident has a proprietary lease on one of the residential units in a large complex. She also has use of the building’s common areas. She lives in a
   A. condominium.
   B. cooperative.
   C. timeshare.
   D. townhome.

99. A special tax levy passes for 5.2 mills annually to pay for new sewers. The levy will be in place for three years. A property has a market value of $296,000. Property is assessed for tax purposes at 45% of its appraised value. What will the 5.2 mill tax levy cost this property owner in total?
   A. $692.64
   B. $1,539.20
   C. $2,077.92
   D. $2,539.68

100. Which of these factors is LEAST LIKELY to be considered by a planning board when reviewing a developer’s proposal for a new subdivision?
    A. building codes
    B. environmental impact
    C. infrastructure needs
    D. zoned permitted use
Glossary
1031 Exchange The Internal Revenue Code Section that allows a taxpayer to sell an investment property and purchase another investment property in its place without paying capital gains on the proceeds from the sale. Also called Like-Kind Exchange or Tax-Deferred Exchange.

Abstract of Title A brief, chronological summary of the recorded documents affecting title to a particular parcel of real property.

Absolute Auction An auction where the property is sold to the highest qualified bidder; there is no minimum bid or reserve or right of confirmation. Also called Without Reserve.

Acceleration Clause A contract clause that gives the lender the right to declare all outstanding payments immediately due upon a default by the borrower.

Acceptance When a party agrees to the terms of an offer to enter into a contract, thereby creating a binding contract.

Accession The acquisition of title to land by its addition to real estate already owned, through human actions or natural processes.

Accounting In an agency relationship, the agent’s fiduciary duty to the principal to strictly account for all monies received.

Accretion A gradual addition to dry land by the forces of nature, as when the tide deposits waterborne sediment onto shoreline property.

Accrued Expense Item on a settlement statement for which the cost has been incurred, but the expense has not yet been paid. Such expenses are considered to be paid in arrears.

Acknowledgment Recognition of validity; a document signers declaration to an authorized official (usually a notary public) that he is signing voluntarily.

Acre A measure of land area that is equal to 43,560 square feet. One square mile contains 640 acres.

Actionable Fraud Fraud that meets certain criteria, so that a victim can successfully sue. The victim must prove the defendant concealed material facts or made false statements (intentionally or negligently) with the intent to induce the victim to enter a transaction, and the victim was harmed by relying on misrepresentations.

Actual Fraud An intentional misrepresentation or concealment of a material fact; when a person actively conceals material information or makes statements that he knows are false or misleading.

Actual Notice Actual knowledge of a fact, rather than knowledge imputed or inferred by law.

Ad Valorem Latin phrase meaning ‘according to value’, used to refer to taxes assessed on the value of property.

Adequate Consideration Consideration that is comparable in value to the consideration the other party to the contract is giving.

Adjustable Rate Mortgage (ARM) A type of loan structure that permits the lender to periodically change or vary the interest rate charged, based on a standard index.

Administrator A person appointed by the probate court to manage and distribute the estate of a deceased person when no executor is named in the will or there is no will.

Adverse Possession The open, notorious, hostile, adverse, exclusive, and continuous possession of another person’s property for a number of years, after which time the adverse possessor may obtain title to the property.

Advertisement— A public notification in any type of media featuring property for sale or rent or marketing brokerage services; must follow guidelines of federal, state, and local fair housing laws.

Affidavit of Title A statement, sworn in front of a notary public or other authorized official, by the seller or grantor of property that identifies the grantor, identifies the grantor’s marital status, and certifies that the grantor has no new judgments, liens, divorces, unrecorded deeds, or other potential title defects since the title examination was completed. It also certifies that the grantor is indeed in possession of the property.

Affiliated Business Arrangement (AfBA) A situation where a person in a position to refer settlement services—or an associate of that person—has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1% in a provider of settlement services and who then refers business to that provider or in some way influences the selection of that provider.

Agency A relationship of trust created when one person (the principal) gives another person (the agent) the right to represent the principal in dealings with third parties.

Agency Coupled with an Interest A situation in which the agent has a personal interest in the subject of the agency, as when one co-owner has been authorized by the others to sell their property.

Agent A licensed broker who represents another (the principal) in a real estate transaction; a person authorized to represent the principal in dealings with third parties (clients or customers).

Aggregate Rent The total rent for the full term of the lease.

Air Rights The right to undisturbed use and control of the airspace over a parcel of land (within reasonable limits for air travel); may be transferred separately from the land.

Alienation The transfer of ownership or an interest in property from one person to another, by any means.
Alienation Clause A mortgage clause allowing the lender to demand the full and immediate payment of the mortgage because the owner transferred or pledged to transfer ownership of the property. Also called Due on Sale Clause.

Allodial System The system of land ownership that allows anyone to own land.

Alluvion Solid material deposited along a shore by accretion. Also called Alluvium.

Amenity A tangible or intangible feature that enhances or adds value to real estate.

Amenity Purchaser A person who values a property based on its ability to fulfill his specific business needs or use, unlike investors who value a property based primarily on its investment return.

American Land Title Association (ALTA) A national association of title companies, abstractors, and attorneys. Members agree to promote uniformity, quality, and professional standards in title insurance policies. Policies issued by ALTA members follow specific guidelines.

Americans with Disabilities Act (ADA) A wide-ranging federal civil rights law, signed in 1990, that prohibits, under certain circumstances, discrimination based on disability.

Amortization Occurs when a loan balance decreases because of periodic installments paid on the principal and interest.

Amperage Amount of electricity going through electric wires, measured in amperes (amps).

Anchor Tenant Major department or chain store strategically located at shopping centers to give maximum exposure to smaller satellite stores. A center may have several anchor tenants. Also called Magnet Store.

Annexation Attaching personal property to land so that it becomes a fixture and the law views it as part of the real property.

Annexation, Actual The process of physically attaching personal property to land, causing it to be a fixture.

Annexation, Constructive Personal property associated with real property in such a way that the law treats it as a fixture, even though it is not physically attached to the real property.

Annexer Person who owns an item as personal property and brings it onto real property, making it a part of the real property.

Annual Percentage Rate (APR) Relationship between the total cost of borrowing and the amount financed, represented as a percentage. Also called Effective Rate of Interest.

Anticipation An economic principle that says value is created by the expectation of future benefits, such as profit on resale, pleasure, tax shelter, production, income, etc. Anticipation is the foundation of the income approach.

Anticipatory Repudiation When one party to a contract informs the other before the set time of performance that he or she doesn’t intend to perform as agreed. The other party may immediately file a lawsuit for breach of contract without making a tender offer. Also called Anticipatory Breach.

Antitrust An area of federal law concerned with maintaining competition in private markets by prohibiting unlawful restraint on trade.

Appraisal A professional estimate or opinion of the value of a piece of property (parcel of land), as of a certain date, that’s supported by objective data.

Appraisal Foundation Nonprofit organization recognized as the authority for professional appraisal standards.

Appraiser A person who estimates the value of property, especially an expert qualified to do so by education and experience.

Appreciation The increase in value of an asset over time.

Appropriative Rights Water rights allocated by government permit, according to an appropriation system. It is not necessary to own property beside the body of water in order to apply for an appropriation permit.

Appurtenance A right that goes along with ownership of real property; usually transferred with the property, but may be sold separately.

Arbitration An alternative to a court proceeding where the parties agree to submit facts and evidence to an impartial third party for a decision.

Area Variance Entitles landowners to use land in a way that is typically not allowed by the dimensional or physical requirements of the zoning law.

Arm’s Length Transaction A transaction that occurred under typical conditions in the marketplace, with each party acting in his or her own best interest.

As of Right Zoning Refers to the landowner’s bundle of rights associated with a property; prohibits discrimination among landowners in a particular area.

Asbestos A fibrous material that was once very common in many building materials because of its insulating and heat-resistant value; can cause breathing issues and illness.

As-Is Clause A statement in a contract that indicates the property is being sold without warranty in its present condition at the time of the contract.

Ascending Bid An auction method where the bidding starts low and the auctioneer asks for more, affording the opportunity for buyers to bid more, before the item is sold to the highest bidder.

Assemblage The act of combining two or more parcels of land into one larger parcel.

Assessed Value The value placed on a property by a taxing authority for the purpose of taxation. With real estate, this value is usually a fraction of true value.

Asset An item of economic value owned by an individual, especially those that can be converted to cash.
**Assignment** 1. The transfer of rights or interests under a contract to another party. 2. A valuation service that is provided by an appraiser as a consequence of an agreement with a client.

**Association Fees** Monthly fees paid by each condominium or cooperative owner for common area expenses such as utilities, management, building maintenance, hazard and liability insurance for the common areas of the property, and other amenities.

**Attachment Lien** A lien intended to prevent property transfer pending the outcome of litigation.

**Attorney-In-Fact** A person specifically designated in an instrument (e.g., power of attorney) to do something legally for another in his stead. An attorney-in-fact has a fiduciary relationship with the principal. An attorney-in-fact need not be an attorney-at-law.

**Auctioneer** A person licensed or authorized to conduct a public auction of item(s) belonging to someone else. In some states, an auctioneer selling real property must be licensed as a real estate broker, whereas in others he or she must be a licensed auctioneer.

**Avulsion** A natural process in which land is removed from one person’s property and deposited onto another’s. Avulsion happens very suddenly, as in a flash flood.

**Bailiff** An agreement that may accompany an earnest money deposit for the purchase of real property as evidence of the purchaser’s good faith and intent to complete the transaction. It is important to note a binder is not a sales contract. It is used, however, by attorneys as the blueprint for creating a sales contract.

**Biweekly Payment Plan** A fixed rate mortgage set up like a standard 30-year conventional loan but payments are made every two weeks instead of every month.

**Blanket Mortgage** A mortgage loan that covers more than one parcel of real estate, usually used to finance entire subdivision developments rather than an individual unit or lot.

**Blind Advertisement** Generally speaking, any real estate advertisement that is used by a licensee regarding the sale or lease of real estate or of licensed activities that does not include the broker’s name or business name. Prohibited in most states.

**Blockbusting** The illegal practice of inducing owners to sell their homes (often at a deflated price) by suggesting the ethnic or racial composition of the neighborhood is changing, with the implication that property values will decline as a result. Also called Panic Selling or Panic Peddling.

**Blueprint** A detailed diagram, usually created by an architect, that is used to evaluate design, determine feasibility, and guide the construction of a structure.

**Boot** Extra, non-like-kind property that can be a part of a like-kind exchange to make up for pricing disparity between like-kind properties.

**Boycott** A concerted refusal by two or more people to deal with a particular person or company.

**Breach** Violation of an obligation, duty, or law.

**Bridge Mortgage** A mortgage loan that occurs between the termination of one mortgage and the commencement of another. When the next mortgage is taken out, the bridge is repaid.
British Thermal Unit (BTU) The amount of heat needed to raise the temperature of one pound of water by one degree Fahrenheit; used to measure the capacity of furnaces and air-conditioning units.

Broker Generically speaking, a person who, for a fee, sells, lists, leases, exchanges, negotiates, or otherwise deals in the real estate of others or represents publicly that he or she does so.

Broker Price Opinion (BPO) The estimated value of a property as determined by a real estate licensee or other qualified individual. Often done at the request of a lender for non-federally related property transactions.

Broker Protection Clause An optional clause that brokers may include in a listing agreement that obligates the seller to compensate the broker even if the property is sold after the listing agreement expires under certain circumstances. Also called: Carryover Provision or Extender Clause.

Brokerage A business that serves as an intermediary between buyers and sellers and/or lessees and lessors of real estate.

Brownfield Any real property where redevelopment or reuse may be complicated by the presence or potential presence of hazardous waste, petroleum, pollutant, or contaminant.

Budget Mortgage A mortgage agreement where payments include principal and interest on the loan, plus 1/12 of the year’s ad valorem property taxes and hazard insurance premiums.

Building Code A means of setting construction standards, requiring builders to use particular methods and materials; regulations establishing minimum standards for construction and materials.

Building Department A group of people responsible for issuing building permits and seeing that building codes are followed and construction and renovations are done by licensed professionals.

Building Efficiency The ratio of usable square footage to rentable square footage.

Building Inspection A process whereby local government officials ensure compliance with state and local building codes.

Building Permits Official documents from a local government or other authority that allow the beginning of a construction or remodeling project.

Bundle of Rights All real property rights that are conferred with ownership, including the right of possession, right of quiet enjoyment, right of disposition, right of exclusion, right of control. Also called Bundle of Sticks.

Buyer Agency Agreement A contract between a buyer and a broker that grants the broker the right to represent the buyer in the purchase or lease of property and that makes the buyer responsible for paying commission to the broker.

Buyer’s Agent A licensed agent representing the interests of the buyer of a property.

Buyer’s Market A situation in the housing market when there are many homes available for sale, but few buyers.

Bylaws Rules and regulations that govern the activities of condominium and cooperative associations, including the purpose of the building, rules for elections and voting, and frequency of board of directors or shareholders meetings.

Cancellation Termination of a contract without undoing acts that have been performed under it; can be done without going to court.

Capital Expense An expense incurred to improve property. Also called Reserves for Replacement.

Capital Gain The taxable profit derived from the sale of a capital asset; the difference between the sales price and the adjusted basis of the property.

Carbon Monoxide Colorless, odorless gas that is a natural byproduct of fuel combustion; dangerous when inhaled.

Cash Flow Measure of cash inflow and outflow from an investment. Positive cash flow means more money is coming into the business than is leaving it. Negative cash flow is the converse.

Cash-on-Cash Return The ratio of income generated by the property to the cash investment (down payment and settlement costs) in the property.

CC&Rs A declaration of covenants, conditions, and restrictions; usually recorded by a developer to create a general plan of private restrictions for a subdivision. Also called Deed Restrictions.

Cease and Desist Order Administrative agency directive to stop an offending activity.

Ceiling Height The height in feet from the floor to the steel girders. Also called Feet Under Steel.

Ceiling The maximum increase or decrease in the periodic payment allowable over the life of an adjustable rate mortgage. Also called Lifetime Cap.

Certificate of Eligibility (COE) A certificate issued by the Department of Veteran’s Affairs to establish status and amount of a veteran’s eligibility to qualify for a loan guarantee.

Certificate of Occupancy Issued to builders after all inspections have been made and the property is deemed fit for occupancy by meeting the appropriate standards for health and safety.

Certificate of Purchase A document that is given to the winning bidder of a real estate tax or foreclosure sale. Once the sale is confirmed, a deed will be issued to convey title.
Certificate of Reasonable Value (CRV) A certificate establishing the current market value of a property based on an approved VA appraisal. Issued by the VA, this certificate places a limit on the amount of a VA guaranteed loan.

Certificate of Title A document prepared by an attorney stating the attorney’s opinion of the status of the title to a piece of property, after performing a title search and reviewing the public records. Also called Opinion of Title.

Chain of Title The chain of deeds and other documents transferring title to a piece of property from one owner to the next, as disclosed in the public record.

Charrette An intense work effort in which a team of design professionals across multiple disciplines works with community stakeholder participants within a highly focused, compressed timeframe to develop a plan.

Chattel A piece of personal property.

Chattel Mortgage A loan that uses only personal property as security.

Civil Rights Fundamental rights guaranteed to all persons by the law. The term primarily refers to constitutional and statutory protections against discrimination based on race, religion, sex, or national origin.

Clearspan Open distance between inside faces of support members.

Client A person being represented by a licensee. Also called Principal.

Closing Disclosure A standardized document that presents a final, detailed accounting for a real estate transaction, listing each party’s debits and credits and the amount each will receive or be required to pay at closing; required for all RESPA-related transactions. Also called Settlement Statement.

Closing The transfer of real property ownership from seller to buyer, according to terms and conditions in a sales contract or escrow agreement; the final stage in a real estate transaction. Also called Loan Consummation or Settlement.

Cloud on the Title A claim, encumbrance, or defect that could make the title to real property unmarketable.

Cluster Zoning Allows developers to provide a varied selection of lot sizes and housing choices within a single area.

Code of Ethics A set of principles and standards based on core values by which a group of professionals are expected to conduct themselves.

Collateral Property pledged as security for a debt.

Collusion Secret agreement or cooperation among people, especially for deceitful or fraudulent purposes.

Combined Loan-to-Value (CLTV) The relationship between the unpaid principal balances of ALL mortgage loans and the appraised value (or sales price if it is lower) of the property.

Commercial Property Property zoned and used for business purposes, such as warehouses, restaurants, and office buildings (as distinguished from residential, industrial, or agricultural property).

Commingling Illegally mixing personal or business funds with money held in trust on behalf of a client.

Commission Compensation paid to a broker for services in a real estate transaction; usually a percentage of the sales price. Commission is negotiable and should be clearly spelled out in a written brokerage agreement.

Common Area Maintenance (CAM) All costs incurred in maintaining the common areas of a commercial property, including parking lot sweeping and repair, snow removal, common utilities, landscaping, and other maintenance tasks. CAM costs are usually prorated among all tenants.

Common Areas The land and improvements in a condominium or cooperative that all residents use and own as tenants in common, such as the parking lot, hallways, and recreational facilities.

Common Law Law that has developed over many years through court decisions and other precedents.

Community Property In some states, property acquired during marriage is owned jointly by the married couple.

Comparables Recently sold properties with similar characteristics (size, room count, design, utility, etc.) that are in close proximity to the property being appraised. Also called Comps.

Comparative Market Analysis (CMA) A method of determining the approximate market value of a home by comparing the subject property to similar homes that have sold, are presently for sale, or did not sell in a given area. Also called Competitive Market Analysis.

Compensation The valuable consideration one person or entity gives to another person or entity in exchange for the performance of some activity or service.

Compensatory Damages Damages awarded intended to compensate a plaintiff for harm caused by the defendant’s act or failure to act, including personal injuries, property damage, and financial loss.

Competency The ability to do something successfully or efficiently.

Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) A federal law enacted by Congress whose primary emphasis is the cleanup of inactive hazardous waste sites and the liability for cleanup costs on arrangers and transporters of hazardous substances and on current and former owners of facilities where hazardous substances were disposed. Also known as Superfund.


Comprehensive Plan A written document prepared by a local planning board that identifies the goals, objectives, principles, guidelines, policies, standards, and strategies for the growth and development of a community, including its housing needs. Also called Master Plan.
Condemnation Occurs when a licensee fails to disclose information that is material to a decision to a party to whom the licensee has such a duty.

Concealment Occurs when a licensee fails to disclose information that is material to a decision to a party to whom the licensee has such a duty.

Condemnation Taking private property for public use, through the government's power of eminent domain. Also called Appropriation. (Condemnation is the action; eminent domain is the right.)

Condition Provision in a deed or other document that makes the parties' rights and obligations dependent on the occurrence or non-occurrence of some event.

Conditional Approval A situation where a lender approves a loan under certain stated conditions.

Conditional Use A land use that does not comply with the general zoning rules for the zone in which it is located, but is permitted because it benefits the public, for example, a hospital in a residential neighborhood. Also called Special Exception or Special Use.

Condominium A property developed for co-ownership, with each co-owner having a separate interest in an individual unit, combined with an undivided interest in the common areas of the property and air space consisting of the area between the walls, floor, and ceiling.

Confidentiality The protection of the client's confidential information. This duty lasts even after the agency relationship has terminated.

Conforming Loan A loan that meets the qualifying standards of Fannie Mae or Freddie Mac, and thus can be sold on the secondary market.

Conformity The principle that says a particular property achieves its maximum value when surrounded by properties similar in style, function, and utility. Also called Homogeneity.

Consent Decree A binding agreement reached before judgment in a court case by which the accused party consents to change its behavior without admitting wrongdoing.

Consideration Anything of value—such as money, goods, services, or promises—that is given to induce another person to enter into a contract. Also called Valuable Consideration.

Construction Loan A temporary loan used to finance the construction of improvements and buildings on land.

Constructive Fraud A negligent misrepresentation or concealment of a material fact; when a person carelessly fails to disclose material information or makes statements that she should realize are false or misleading. Also called Negligent Misrepresentation.

Constructive Notice Knowledge of a fact imputed to a person by law. A person is held to have constructive notice of something when he or she should have known it, even if he or she did not know it. Everyone is considered to have constructive notice of the contents of recorded documents, since everyone is expected to protect their interests by searching the public record.

Consumer A person or entity seeking or receiving licensed activities.

Consumer Financial Protection Bureau (CFPB) An agency funded by the Federal Reserve with rulemaking and enforcement authority over many consumer financial laws. Established under provisions of the Dodd-Frank Act.

Consumer Price Index (CPI) An index published monthly by the United States Bureau of Labor Standards (BLS) considered by many to be the basic indicator of inflation in the U.S.

Contingency Clause A provision in a contract, deed, law, regulation, guideline, etc. that makes the parties' rights and obligations depend on the occurrence (or nonoccurrence) of a specified event. Also called Condition, Escape Clause, Subject to Clause, or Kick-Out Clause.

Continuance A title search performed just prior to settlement to bring a preliminary title report up to date and ensure that no intervening rights to the property have come up. Also called: Bring-Down or Continuation.

Contract An agreement between two or more parties to do, or not do, something. Contracts are legally enforceable promises, with the law providing remedies for breach.

Contract Rent What tenants are actually paying in rent, as stated in the terms of the lease.

Contractual Capacity The legal ability to enter into a contract.

Contribution The principle that a specific item or feature of a property is worth only what it actually contributes in value to that parcel of real estate.

Conventional Loan A loan made by an institutional lender or a private party with real estate as security for the loan that the government neither guarantees nor insures.

Conversion The illegal use of another's funds or other property for one's own personal or business purposes.

Conveyance The act of transferring interest in property from one person to another.

Cooperating Agent An agent who works with a listing agent to sell property in a real estate transaction; the selling agent who finds a buyer for the listed property. Also called Cooperating Broker.

Cooperative A type of property ownership under which residents have the right to occupy a unit by purchasing stock shares in the corporation that owns the property.

Co-Ownership Any form of ownership in which two or more people share title to a piece of property, holding undivided interests. Also called Co-tenancy or Concurrent Ownership.

Corporation An association organized according to strict regulations, in which individuals purchase ownership shares; regarded by the law as an artificial person, separate from the individual shareholders.

Correction Deed A deed used to correct minor mistakes in an earlier deed, such as misspelled names or errors in the legal description of the property. Also called Deed of Correction or Deed of Confirmation.
Correction Line In the government survey system, lines that are established at 24-mile intervals (or at every four township lines) north and south of a baseline, re-establishing the six-mile width between the range lines to account for the curvature of the earth.

Corrective Maintenance Repairing or restoring broken or failed equipment to a specified condition.

Cosmetic Maintenance Maintenance that increases a property's appeal.

Cost The amount needed to develop, produce, or build something.

Cost Approach An appraisal method that estimates the value of real estate by establishing the cost new of replacing or reproducing the improvements, minus depreciation, plus the value of the site.

Cost Manuals Books, electronic media, and online sources that give estimated construction costs for various types of buildings in different areas of the country.

Cost of Money The interest rate that people or businesses must pay to use another's money for their own purposes.

Counteroffer A response to an offer to enter into a contract, changing some of the terms of the original offer. A counteroffer is a rejection of the original offer (not a form of acceptance) and does not create a binding contract unless the new counteroffer is accepted by the original offeror.

Counterofferee A person who receives a counteroffer or to whom a counteroffer is made.

Counterofferor A person who makes a counteroffer.

Covenant A contract, promise, or a guarantee (express or implied) in a document such as a deed or lease.

Covenant of Quiet Enjoyment A guarantee that a buyer has the right to exclusive, undisturbed possession of an estate, and the right to be undisturbed by the previous owner or anyone else claiming an interest in the property.

Crawl Space Unfinished space below the first floor of a house, less than a full story in height, usually containing plumbing and other functional elements.

Credit A sum of money that is to be received.

Credit History Record of debt repayment, detailing how a borrower has paid debts and obligations in the past, used to predict whether the borrower is likely to pay debts in the future.

Credit Report A listing of a borrower's credit history, including the amount of debt, record of repayment, job info, address info, etc.

Credit Scoring A method in which numerical values are assigned to different aspects of a borrower's loan application and used by lenders to gauge creditworthiness and assess credit risk.

Cubic Feet Length x width x depth = cubic feet. Divide cubic feet by 27 to find cubic yards.

Culpable Negligence Occurs if a licensees operates in a reckless, careless, and excessively negligent manner. Culpable negligence is for which one can be held legally accountable.

Curtesy An interest held by a married person in the real property owned by a spouse; refers to a husband's interest in his wife's property. Not recognized in all states.

Customer A party to a transaction with whom a real estate licensee does not have a fiduciary duty or relationship, but with whom a licensee must be honest and fair.

Days on Market (DOM) The time period between listing a property and either selling or removing it from the market.

DD-214 A Certificate of Release or Discharge from Active Duty, or DD-214, issued by the Department of Defense. The DD-214 identifies the character of service and reason for discharge (honorable, dishonorable, etc.).

Debit A sum of money that is owed.

Debt The amount of money owed on a note or other promise to pay.

Debt Service The amount of money paid at regular intervals toward reducing the principal and interest owed on a debt.

Debt-to-Income Ratio The relationship of a borrower's total monthly debt to gross monthly income, expressed as a percentage (Total Debt ÷ Income = Ratio %). Debt obligations include housing and long-term debts with more than 10 payments remaining. Also called Total Debt Service Ratio or Back-End Ratio.

Dedication The donation of real property by a private owner to the public.

Deed A written instrument transferring the grantor's ownership of, or interest in, real property.

Deed in Lieu of Foreclosure Process by which the deed to a property is given by a borrower to the lender to avoid foreclosure.

Deed of Trust A security instrument placing into the hands of a disinterested third party (a trustee) a specific financial interest in the title to real property as security for the payment of a note, making the lender the beneficiary. Also called Trust Deed.

Deed Restriction Limitations placed in a deed by a grantor that restrict the way in which the land may be used, improved, or maintained.

Default Failure to fulfill an obligation, duty, or promise, as when a borrower fails to make payments, a tenant fails to pay rent, or a party fails to perform a contract. A mortgage, note or other document will define what constitutes default.
Defeasance Clause A clause used to defeat or cancel a certain right upon the occurrence of a specific event.

Defeasible Fee A type of freehold estate conveying ownership interest that comes with a condition. Also called Qualified Fee.

Deficiency Judgment The debt that remains due and payable by the borrower after a sheriff’s sale of property.

Delivery and Acceptance A requirement for the legal transfer of property through a deed. Delivery refers to the grantor’s intention to transfer the property’s title and signing a deed; acceptance refers to the grantee’s receiving the deed while the grantor is alive.

Density The number of housing units per area of land, often expressed as the number of dwellings per acre.

Depreciation A loss in value of a piece of property over the time it is expected to be useful for any reason.

Derogatory Credit Credit history showing previous problems in meeting financial obligations.

Descending Bid An auction method where the auctioneer begins with a high asking number, lowering the asking price until the first person speaks, thereby winning the auction. Also called Dutch Auction.

Descent An operation of law when real property is transferred to an heir after the death of the owner who leaves no will (intestate).

Designated Agency A contractual relationship between a broker and a client in which one or more licensees associated with the broker are appointed to represent the client in an in-house transaction. Also called Split Agency.

Designated Agent A licensee appointed by a broker as the legal agent of a client. Also called Split Agent.

Development An activity that changes undeveloped property into developed property.

Devise To transfer real property by will; real property transferred in a will.

Direct Capitalization Rate A rate of return, stated as a percent, used to derive a value opinion from the anticipated net operating income a property could generate. It is used for direct capitalization in the income approach. Also called Cap Rate or Rate.

Disability A physical or mental impairment that substantially limits or curtails one or more major life activities.

Discharge of Mortgage Required once a borrower’s loan is paid off. The lender issues the discharge of contract, and the borrower should record this document. Also called Release of Lien or Satisfaction of Mortgage.

Disclosure A real estate licensee’s fiduciary obligation to reveal material facts or defects.

Discount Point A form of pre-paid interest that a lender charges to increase the yield on a lower-than-market interest rate loan. One point equals 1% of the loan amount; one discount point equals approximately 1/8 of a percent.

Discount Rate The interest rate charged by Federal Reserve Banks on loans to member commercial banks.

Discrimination Treating people unequally because of their race, religion, sex, national origin, age, or some other characteristic of a protected class, in violation of civil rights laws.

Disintermediation The movement of money out of savings accounts and into higher yield investments, such as corporate securities or government instruments.

Disparate Impact When a law that isn’t discriminatory on the face of it has a greater impact on a minority group than it has on other groups. Also called Disparate Effect.

Disparate Intent An intentional decision to treat some people differently than others in a similar situation. Also called Disparate Treatment.

Doctrine of Emblements A rule that allows a tenant farmer to re-enter the land to harvest crops that were planted by the tenant farmer even after the land has been sold to a new owner.

Doctrine of Part Performance A legal doctrine that allows a court to enforce an oral agreement that should have been in writing, when one party has taken irrevocable steps to perform his or her side of the bargain, and failure to enforce the contract would result in an unjust benefit for the other party.

Dominant Tenant A person with easement rights on another’s property; either the owner of a dominant tenement or someone who has an easement in gross.

Dominant Tenement Property that receives the benefit of an appurtenant easement.

Double Net Lease A lease in which the tenant pays two of the expenses associated with property ownership, in addition to paying the rent. Also called Net-Net.

Dower The interest held by a married person in the real property owned by a spouse; generally refers to a wife’s interest in her husband’s property. Not recognized in all states.

Down Payment The amount of money a buyer pays to obtain a property, in addition to the money that the buyer borrows.

Dual Agency An agency relationship in which a licensee represents both buyer and seller (or both landlord and tenant) in the same transaction. Usually requires informed written consent from both parties.

Dual Agent A licensee who represents both the buyer and the seller (or both landlord and tenant) in a single real estate transaction.

Due Diligence Investigation to discover facts or liabilities about a property prior to its purchase.
Earnest Money Money offered as an indication of good faith regarding the future performance of a purchase agreement.

Easement A nonpossessory interest and an encumbrance on property that grants the right to use another person's real property for a particular purpose.

Easement Appurtenant The right acquired by the owner of one parcel of land to use another's adjacent land for a specific purpose. There must be two tracts of land; one becomes the dominant tenement (it benefits from the easement), and the other becomes the servient tenement.

Easement by Prescription An easement created by open and notorious, hostile and adverse use of another person's land for a specific period of time determined by state law. Prescriptive use does not have to be exclusive (the owner may be using the property, too), and the user does not acquire title to the property. Also called Prescriptive Easement.

Easement in Gross An easement that benefits a person or company, rather than benefiting another parcel of land.

Economic Base The main business or industry in an area that supports and sustains the community.

Economic Life The time during which a building can be used for its intended purpose and generate more income than is paid out for operating expenses. Also called Useful Life.

Effective Age The age of a structure based on the actual wear and tear that the building shows from physical, functional or external obsolescence; not necessarily the structure's actual age.

Effective Date The date for which value was established when doing an appraisal.

Efflorescence A white powdery deposit on the surface of foundation walls or floor slabs created when water penetrates the wall or floor, combines with salts within the masonry, and brings those salts to the surface.

Elevation Vertical measurement above or below a fixed reference point, most commonly sea level.

Emblement A crop that is planted and cultivated through someone's labor and industry. Emblements are considered to be personal property. Also called Fructus Industriales.

Eminent Domain The government's constitutional power to take private property for public use, as long as the owner is paid just compensation. (Condemnation is the action; eminent domain is the right.)

Enabling Law Legislation in which a governmental body grants another entity the authority or power to take certain actions.

Encapsulation The process of applying a sealant to asbestos-containing material, which penetrates the material's surface, preventing the release of the dangerous fibers into the air.

Encroachment A physical object intruding onto neighboring property, often due to a mistake regarding the boundary.

Encumbrance Any claim, lien, charge, or liability that affects or limits the fee simple title to real property.

ENERGY STAR A program, managed by the U.S. Environmental Protection Agency, that sets standards for energy-efficient consumer products and homes.

Enforceable Contract A contract that would be upheld by the courts. The requirements for an enforceable contract are: capacity, mutual consent (offer and acceptance), lawful objective, and consideration. In addition, certain contracts must be in writing to be enforceable.

Entitlement 1. The maximum dollar amount of a loan guarantee to which an eligible veteran is entitled. 2. The process of obtaining legal approvals for the right to develop property for a particular use.

Environmental Impact Statement (EIS) A report required for certain development projects that identifies the positive and negative effects that the proposed action would have on the environment and its inhabitants.

Environmental Protection Agency (EPA) The federal agency tasked with creating and enforcing environmental protection standards, helping others with environmental pollution problems, and providing research on environmental issues.

Environmental Site Assessment (ESA) A due diligence analysis of real property to determine the possibility of environmental contamination. An ESA can have up to four phases: I-investigation; II-testing; III-remediation; IV-management.

Equal Credit Opportunity Act (ECOA) A law that requires all lenders to make credit available with fairness and without discrimination based on race, color, religion, national origin, age, sex, marital status, or receipt of income from public assistance programs.

Equitable Right of Redemption The right of a debtor to redeem the property from foreclosure proceedings prior to confirmation of sale.

Equitable Title Any present right to acquire legal title to property.

Equity An owner's unencumbered interest in property; the difference between the value of the property and the liens, such as a mortgage, against it.

Equity Financing Funds provided by one or more investors in return for an interest in the property.

Erosion A gradual loss of soil due to the action of wind, water, or other forces.
Errors and Omissions Insurance (E&O)  Insurance that protects real estate licensees from liability due to mistakes or negligence. It does not cover claims related to fraud or discrimination.

Escalation Clause  A lease clause that provides for an increase in rent to reflect increases in expenses paid by the landlord, such as real estate taxes, operating costs, and cost of living expenses. Also called Escalator.

Escape Clause  A clause, term, or condition in a contract that allows a party to that contract to avoid having to perform the contract.

Escheat  The reversion of property to the state (or, in some states, the county) after a person dies without leaving a valid will or having any heirs.

Escrow Account  1. A separate account maintained by a broker for the deposit of clients’ money (i.e., good faith deposits). Also called Trust Account. 2. The account a lender maintains to hold a borrower’s monthly payments for property insurance and property tax until those bills are due. Also called Reserve Account or Impound Account.

Escrow Closing  A settlement procedure conducted by a disinterested third party, often an escrow agent, where the buyer and seller are not present.

Escrow Reserves  An account maintained by a lender for the deposit of borrowers’ extra 1/12 monthly deposits to cover next year’s insurance and tax payments.

Established Business Relationship (EBR)  A relationship that may allow a telemarketer or seller to call a consumer for up to 18 months after the consumer’s last purchase, delivery, or payment (even if the consumer’s number is on the National Do Not Call Registry).

Estate  A possessory interest in real property; either a freehold estate or a leasehold estate.

Estate for Years  A leasehold estate set to last for a definite period (e.g., one week, three years), after which it automatically terminates. Also called Term Tenancy.

Estoppel  A legal doctrine that prevents a person from asserting rights or facts that are inconsistent with his earlier actions or statements, when he failed to object (or attempt to “stop”) another person’s actions.

Ethics  The fundamental principles of honesty and integrity that guide a person’s behavior.

Eviction, Actual  The legal process of forcing someone off property or preventing someone from re-entering property.

Eviction, Constructive  When a landlord’s act (or failure to act) interferes with the tenant’s quiet enjoyment of the property, or makes the property unfit for its intended use, to such an extent that the tenant is forced to move out.

Eviction, Retaliatory  When a landlord evicts a tenant in retaliation for complaining about code violations or for participating in a tenants’ rights group.

Eviction, Self-help  When a landlord uses physical force, a lockout, or a utility shutoff to remove a tenant, instead of going through the legal process.

Evidence of Title  Evidence of title to real estate is provided through a title report or issuance of title insurance.

Exclusive Agency Buyer Agency Agreement  A contract between a buyer and broker in which the broker earns commission only if he is the broker who finds the property the buyer eventually purchases.

Exclusive Agency Listing  An agency contract between a seller and a broker that entitles the broker to a commission if anyone other than the seller finds a buyer for the property during the listing term.

Exclusive Buyer Agency Agreement  A contract between a buyer and broker in which the broker earns the negotiated fee even if the buyer purchases property through another broker or finds it on his own.

Exclusive Right to Sell Listing  An agency contract between a seller and a broker that entitles the broker to a commission if anyone, including the seller, finds a buyer for the property during the listing term.

Executed Contract  A contract in which both parties have fully performed their contractual obligations.

Executor  A person appointed in a will to carry out the provisions of the will. Sometimes called Executrix if female.

Executory Contract  A contract in which one or both parties have not yet completed performance of their contractual obligations.

Express Authority  Actual consent to represent intentionally given by agreement—either oral or written—by a principal to an agent.

Express Contract  An agreement that’s been expressed in words, either spoken or written.

External Obsolescence  When something outside of a property and outside of the control of a property owner makes it less desirable. Also called Economic Obsolescence.

Facilitator  A licensee who assists in the successful completion of a real estate transaction but has no agency relationship with and, therefore, no fiduciary obligation to either party.

Fair Housing Act  Common name for Title VIII of the Civil Rights Act of 1968 and its amendments.

Familial Status  A protected group under the federal Fair Housing Act, making it illegal to discriminate against a person for being the parent or guardian of a child under 18 years of age.

Feasibility Study  An analysis of the potential return on investment to determine if a proposed project is economically feasible.

Fee Simple Absolute  The greatest estate (ownership) one can have in real property because it is freely transferable and inheritable, and of indefinite duration, with no conditions on the title. Also called Fee, Fee Simple, or Fee Title.
Fee Simple Determinable A defeasible fee that terminates automatically if certain conditions occur. The grantor (or his or her heirs) has a possibility of reverter. Also called Determinable Fee.

Fee Simple Subject to a Condition Precedent A condition in which the grantor retains title to the estate until a specific condition occurs.

Fee Simple Subject to a Condition Subsequent A defeasible fee that the grantor may terminate if conditions stated in the deed are not met. The grantor (or his or her heirs) has a right of re-entry.

FHA-Insured Loan A mortgage loan insured by the Federal Housing Administration that protects the lender against losses from default.

Fiduciary Person in a position of trust, held by law to high standards of good faith and loyalty.

Fiduciary Deed A deed executed by a person in a position of trust, held by law to high standards of good faith and loyalty.

First Substantive Contact An event triggering agency disclosure (e.g., prior to entering into a listing agreement, prior to showing a property, at an open house when a buyer displays serious interest, etc.).

Fixed Expenses Ongoing operating expenses that do not vary based on occupancy levels of the property (e.g., taxes, insurance).

Fixed Fee Commission agreement by which a fixed dollar amount is paid for the performance of specific real estate services; payment usually requires the successful completion of the transaction.

Fixed Rate Loan A loan for which the interest rate remains constant.

Fixture A man-made attachment; an item of personal property that has been attached to or closely associated with real property in such a way that it has legally become part of the real property.

Flipping Purchasing a property and quickly reselling it for a profit.

Floodplains Land areas adjacent to rivers and streams that are subject to recurring flooding.

Floor Area Ratio The maximum size of a building permitted on a development site according to zoning requirements. The floor area ratio (FAR) is typically stated as a percentage, such as 25%, 30%, etc.

Floor Load Capacity The weight (pounds per square foot) or load that the floor of a structure can handle.

Footer The support for the foundation of a building. Footers are installed below the frost line, and are wider than the foundations that they support.

Forbearance Agreement When the lender agrees to temporarily reduce, postpone, or suspend the mortgage payment and not proceed with foreclosure as long as the borrower brings the loan current within the specified time.

Forcible Entry and Detainer Action A summary legal action to regain possession of real property; especially, a lawsuit filed by a landlord to evict a defaulting tenant and regain possession of property. Also called Unlawful Detainer Action.

Foreclosure The remedy a lienholder uses to force the sale of property, applying the proceeds of the sale toward debt satisfaction.

Foreclosure Action A lawsuit filed by a creditor to begin foreclosure proceedings.

Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) A federal law that imposes income tax on foreign persons selling or otherwise disposing of their interest in real property.

Foundation The basic structure on which the rest of the building will sit. A foundation can be concrete slab, pier and beams, crawl space, or basement.

Framing The basic load-bearing skeleton of the house to which interior walls, exterior walls, and roof are attached.

Fraud A material misrepresentation that is known to be false or made recklessly, is made to induce an act, induces an act in reliance on the misrepresentation, and causes injury. Also called Fraudulent Dealing.

Freehold Estate A possessory interest in real property of uncertain (and often unlimited) duration; an ownership estate in real property; either a fee simple or life estate. The holder of freehold estate has title.

Friable A characteristic of asbestos in which it can crumble easily or become powdery when manipulated by hand, releasing particles into the air.

Frontage The dimension across the access side of a parcel of land. The access could be a road, railroad tracks, or water. When referring to lot size, frontage is the first number. Also called Front Foot.

Fructus Naturales Naturally occurring plants (“fruits of nature”) generally considered part of real property. Also called Natural Attachments.

Functional Obsolescence When an improvement is less desirable because of something inherent or lacking in the design.

-General Agent A person authorized to handle a principal’s affairs in one area or in specified areas.

General Lien A lien against all property of a debtor, instead of a particular piece of property.

General Partnership A partnership in which each member has an equal right to manage the business, share in the profits, and carry equal responsibility for the partnership’s debts.

General Warranty Deed A deed in which the grantor warrants the title against any and all defects that might have arisen before or during his or her period of ownership. Also called Standard Warranty Deed or Simple Warranty Deed.
Genuine Assent  Consent given freely to create a binding contract. If offer or acceptance is given as a result of fraud, undue influence, duress, or mistake, then the contract is voidable by the victimized party.

Good Consideration  Love and affection.

Government Survey System  Legal description for land referencing principal meridians and baselines designated throughout the country. Also called Rectangular Survey System.

Government-Sponsored Enterprise (GSE)  A privately held corporation with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy.

Graduated Lease  A lease under which rental increases are made at scheduled intervals for specific amounts.

Graduated Payment Buydown  A temporary buydown plan where payment subsidies, usually from a seller or developer, in the early years of the loan keep payments low, but payments increase regularly. They're sufficient to fully amortize the loan by their maturity.

Grantee  Person receiving a grant of real property.

Granting Clause  A deed clause stating a grantor's intent to transfer an interest in real property.

Grantor  A person who conveys his or her services, but still owes the principal all statutory obligations due to every client.

Gross Income Multiplier  A conversion factor derived from the sales price of a comparable rental property divided by its gross monthly rent and any other miscellaneous income. This factor is multiplied by the estimated gross rent of the subject to estimate its value.

Gross Lease  A lease for which the tenant pays a fixed amount to the landlord and the landlord pays all expenses related to ownership.

Gross Living Area  Residential space that is finished, heated, and above grade. Garages, finished basements, and storage areas do not count in GLA. Also called Livable Area.

Gross Rent Multiplier  A conversion factor derived from the sales price of a comparable rental property divided by its gross monthly rent. This factor is multiplied by the estimated gross rent of the subject to estimate its value. Also called Gross Monthly Rent Multiplier (GMRM).

Growth Equity Mortgage  A fixed rate mortgage set up like a conventional loan, but payments increase regularly.

Guardian's Deed  A deed authorized by a guardian, a person assigned by a court to handle the affairs of an incapacitated person.

H-  

Habendum Clause  A clause in a deed, usually beginning with “to have and to hold,” that describes the type of estate granted.

Half Timbering  A construction method in which the external walls have exposed wood framing constructed of timber frames, with other materials such as plaster or brick filling the space between them.

Highest and Best Use  The most profitable, legally permitted, feasible, and physically possible use of a piece of property.

Holder in Due Course  One who acquires a negotiable instrument in good faith and for consideration, and thus has certain rights above the original payee.

Holdover Tenant  A lessee who remains in possession of property after the lease has expired; a tenant who refuses to surrender possession of property at the tenancy’s end.

Home Acquisition Debt  A loan that a taxpayer takes out to buy, build, or substantially improve a qualified home.

Home Energy Rating System (HERS)  A measurement of a home’s energy efficiency used primarily in the United States; in the HERS Index, the higher the score, the less energy efficient the home is.

Home Equity Debt  A loan that does not qualify as home acquisition debt but is secured by a qualified home.

Home Equity Line of Credit (HELOC)  Available money that a homeowner can borrow, secured by a second mortgage on the principal residence. The homeowner can access HELOC funds at any time up to a predetermined borrowing limit and use them for non-housing expenditures.

Home Equity Loan  A loan taken by a homeowner that is secured by a mortgage on her principal residence; not for the purchase of the property.

Home Inspection  An unbiased, systematic, noninvasive, visual inspection of a home.

Home Inspection Report  A written report prepared by a home inspector issued after a home inspection.

Home Warranty  A contract between a property owner and home warranty company that provides coverage for the repair or replacement of named components in the home for a specified period of time, such as one year.

Homestead  A statutory or legal life estate recognized in some states that protects the estate belonging to a deceased person for the use of a surviving spouse and minor children.

Horizontal Property Acts  A generic name given to state laws that create the legal framework that allows a condominium form of ownership. These acts make it possible for lenders to provide mortgages on condominiums, for tax authorities to assess property taxes, etc.

Housing Expense Ratio  The relationship of a borrower's total monthly housing expense to gross monthly income, expressed as a percentage (Total Housing Expense ÷ Income = Ratio%). Also called Income-to-Payment Ratio or Front-End Ratio.
HVAC Heating, ventilation, and air conditioning.

Hypothecation The act of pledging property to be the security for a loan without giving up possession of it (as with a mortgage).

**Implied Agency** An agency created through the behavior (actions or words) of one or both parties.

**Impact Fees** Assessments against a new development to cover some or all of the costs associated with expanding public services to meet the demand generated by the new development.

**Implied Agency** An agency relationship created through the behavior (actions or words) of one or both parties.

**Implied Contract** An agreement that has not been put into words but is implied by actions of the parties.

**Implied Warranty of Habitability** An implied guarantee that the property is safe and fit for human habitation; treated by law as an implicit provision of every residential lease, regardless of the express terms of the lease. Also called Covenant of Habitability.

**Improvements** Additions to real property; can be natural (e.g., trees or a lot feature), but usually they are man-made; substantial fixtures, such as buildings.

**Incentive Zoning** A system by which developers receive zoning incentives on the condition that they provide specific physical, social, or cultural benefits to the community.

**Incidental Authority** The authority to do everything reasonably necessary to carry out the principal's express orders.

**Income Approach** An appraisal method that estimates the value of real estate by analyzing the amount of revenue, or income, the property currently generates, or could generate. Also called Capitalization Approach.

**Independent Contractor** Under common law, a person who contracts to do a job for another, but who maintains control over how the task is carried out, rather than following detailed instructions.

**Index** A statistical report that is generally a reliable indicator of the approximate change in the cost of money; often used to adjust the interest rate of adjustable rate mortgages.

**Index Lease** A lease in which the amount of the rent is tied to some common index indicator such as the Consumer Price Index or the Wholesale Price Index. As the agreed-upon index increases, the rent goes up by the same percentage of change.

**Inflation** An increase in the cost of goods or services, or too many people wanting too few goods.

**Infrastructure** Physical elements necessary to support the population, such as power plants and grids, water and sewage systems, and roads.

**In-House Transaction** A situation in which a single brokerage represents both the buyer and seller in the same real estate transaction.

**Injunctive Relief** A court-ordered prohibition against a specific act or conduct, as opposed to a judgment for money. Also called Injunction.

**Inquiry Notice** When circumstances should have alerted someone to a possible problem prompting further investigation, a person may be held to have had notice of the problem even if he or she does not have actual knowledge of it.

**Inspection Contingency** The contract clause that gives a buyer the right to have a home inspected during a specified period of time.

**Inspection Period** The time frame specified in the purchase agreement during which the buyer has the opportunity to conduct an inspection.

**Insulation** A material that is used to slow the flow of heat.

**Insurable Title** Title to property that a title insurance company has agreed to insure against defects that could affect its ownership or value.

**Interest** 1. A right or share in something, such as a parcel of real estate. 2. A charge a borrower pays to a lender for the use of the lender's money.

**Intermediation** The flow of funds through financial intermediaries (such as banks and thrifts) on its way to borrowers. Money deposited at financial institutions that then make the money available to corporate borrowers is an example of intermediation.

**Intestate** The state of dying without making a will, causing the decedent's estate to pass on according to the state laws of descent and distribution.

**Inverse Condemnation** When a property owner sues the government for failing to pay just compensation when it exercised its right of eminent domain.

**Involuntary Alienation** When title to property is transferred during the owner's lifetime without his consent.

**Involuntary Lien** A lien that arises by operation of law, without the consent of the property owner.

**IRS Form 1099-S** A tax form indicating the seller's proceeds from the sale or transfer of real estate that a settlement officer submits to the Internal Revenue Service.

**IRV Formula** A simple calculation for finding the net operating income ($I$), the capitalization rate ($R$), or the value ($V$) of an investment property. When any two factors are known, the third can be determined. Also called Capitalization Rate Formula.

**Joint Tenancy** A form of co-ownership in which the co-owners have equal undivided interests and the right of survivorship. Requires the unities of time, title, interest, and possession.

**Joint Venture** Two or more individuals or companies joining together for one project or a series of related projects, but not as an ongoing business.

**Joists** Long beams of wood or steel that span the perimeter a foundation or the load-bearing walls of a roof.

**Judgment Lien** A recorded claim against another for a wrongful act, as ordered by a court (often for money owed). The result of a judgment lien can be the forced public sale of real estate.
Judicial Foreclosure A lawsuit filed by a lender or other creditor to foreclose on a mortgage or other lien; a court-ordered sheriff’s sale of the property to repay the debt.

Jumbo Loan A loan that exceeds the maximum loan amount that Fannie Mae and Freddie Mac will buy, making it nonconforming.

Junk Fees Charges assessed to a borrower by the loan originator that serve little if any function and are often hidden in the mortgage documents. Junk fees may or may not pay for an actual service to the borrower, but they typically are not known to the borrower prior to signing.

Just Compensation Generally, the fair market value for property; a requirement when the government exercises its constitutional power of eminent domain.

Land Contract A real estate installment contract under which the buyer (vendee) makes payment to the seller (vendor) in exchange for the right to occupy and use the property. No deed or title is transferred until all, or a specified portion of, payments have been made. Also called Installment Sales Agreement, Contract for Deed, or Land Sales Contract.

Land Lease A lease under which the tenant leases the land from the owner, but the tenant owns the building. Also called Ground Lease.

Land Trust A trust in which real estate is the only asset. The beneficiary has the right to possess the property as well as receive income or proceeds from its sale. The trustee manages the real estate as directed by the beneficiary, whose identity is usually kept confidential.

Latent Defect A defect that is not visible or apparent; a hidden defect that would not be discovered in a reasonably thorough inspection of property.

Lawful and Possible Objective The purpose or objective of a contract must be lawful at the time the contract is made.

Lead A bluish-white metal added to both exterior and interior paint as a drying agent and for pigmentation before 1978. Also, once used for pipes in plumbing systems in homes and businesses; can cause health issues, especially for children.

Lease 1. Conveyance of a leasehold estate from the fee owner to a tenant. 2. A contract for which one party pays the other rent in exchange for possession of real estate.

Lease Purchase A contract where a tenant pays rent for temporary possession but is obligated to complete the purchase at some point in the future.

Lease with Option to Buy A contract where a tenant pays rent for temporary possession and has the option to purchase the property at some point in the future.

Leased Fee Estate The owner’s interest in a leased estate, which is reversionary in that possession reverts to the landlord (lessor) when the lease ends.

Leasehold Estate The temporary interest that an owner gives to a tenant (lessee) that includes the right of possession and quiet enjoyment, without title. Also called Less-Than-Freehold Estate.

Leasehold Improvement A fixture attached to real property by a landlord for the use of a tenant.

Legal Description A precise description of a specific piece of property; the most common systems are lot and block, metes and bounds, rectangular (or government) survey.

Legal Title 1. The interest in property held by the rightful owner. 2. The seller’s interest in property under a land contract. Also called Actual Title.

Lessee A person who leases property. Also called Tenant.

Lessor A person who leases property to another. Also called Landlord.

Leverage The investment strategy of using borrowed funds, such as a mortgage, to increase the potential return on an investment.

License Revocable, non-assignable permission to enter another person’s land for a stated purpose.

Licensee A person licensed under state law to practice real estate.

Lien A non-possessory interest in property, giving a lienholder the right to foreclose if the owner does not pay a debt owed the lienholder.

Lien Theory State A state in which real estate mortgages are regarded as liens; title remains with the mortgagor as long as no default occurs.

Life Estate An interest in real property, the duration of which is limited by the life of its owner or another designated person.

Life Estate Pur Autre Vie A life estate “for another’s life,” where the measuring life is someone other than the life tenant.

Life Tenant Someone who owns a life estate; the person entitled to possession of the property during the measuring life.

Limited Common Areas Areas in a condominium or cooperative owned by all but used by only one owner (e.g., a balcony or designated parking space.)

Limited Liability Company A type of business organization that has the limited liability protection of a corporation and the tax advantages of a partnership.
Limited Partnership A partnership comprised of one or more general partners and one or more limited partners. Limited partners have no say in partnership matters and their liability is limited to their investment.

Limited Warranty Deed A deed in which the grantor warrants title only against defects arising during the time he owned the property and not against defects arising before his ownership. Also called Special Warranty Deed.

Linear Feet The total length in feet around a perimeter. For example, a 20-foot x 30-foot garden will take 100 linear feet of fencing (20 + 30 + 20 + 30 = 100).

Liquidated Damages A sum of money that the parties to a contract agree to in advance that will serve as compensation in the event of breach. Often, it’s the forfeiture of the earnest money deposit in purchase contracts.

Liquidity The ability to convert an asset into cash quickly without the loss of principal.

Lis Pendens A recorded notice stating that there is a lawsuit pending that may affect title to the defendant’s real estate.

Listing Agreement A written agency contract between a seller and a broker, stating that the broker earns a commission for finding (or attempting to find) a buyer for the seller’s real property. A listing is a personal services contract.

Littoral Rights Water rights of landowners whose land touches a commercial lake, sea, or ocean.

Load Factor The ratio of rentable square footage to usable square footage. Also called Add-on Factor.

Loan Estimate The disclosure of loan terms, annual percentage rate and other credit costs, and estimated settlement costs that lenders must present to borrowers within three business days of a completed loan application in order to satisfy provisions of the Truth in Lending Act and the Real Estate Settlement Procedures Act.

Loan-to-Value Ratio (LTV) The relationship between the loan amount and the sales price or appraised value of the property, whichever is less.

Lock-In Agreement A written or electronically transmitted agreement between a lender and an applicant for a mortgage loan which, subject to the terms set forth in the agreement, obligates the lender to make a mortgage loan at a specified rate and a specific time period.

Lockbox A secured container for a key, usually attached to a house that’s for sale, accessible only by authorized individuals.

Lot A parcel of land; a parcel in a subdivision.

Lot and Block System The type of legal description used for platted property. The description states only the property’s lot number and block number in a particular subdivision. To find out the exact location of the property’s boundaries, one can consult the plat map for that subdivision at the county recorder’s office.

Loyalty A fiduciary duty that requires a real estate licensee to put the principal’s interests above all others’ interests, including her own.

Management Agreement A written agreement that governs the relationship between the property owner/investor and the property manager, and outlines the duties of the property manager.

Management Proposal A plan created by the property manager for overseeing the principal’s property, including market analysis, and developing a variety of financial reports, including the operating budget.

Margin The difference between the index value and the interest rate charged to the borrower with an adjustable rate mortgage; the lender’s profit.

Marital Property Property acquired by either a spouse or a legal partner during the course of a marriage or civil union.

Market A place where buyers and sellers come together to buy and sell services or products. Markets can be divided into sub-markets.

Market Allocation An antitrust violation where competitors agree to not compete with each other in specific markets by dividing up geographic areas, types of products, or types of customers. Also called Territory Allocation.

Market Analysis An analysis of supply and demand to determine if a market exists for a proposed project.

Market Position The position an agent’s listing is in compared to similar homes in the same neighborhood at a similar price.

Market Rent What the property could rent for in the open market if unencumbered by any lease and available.

Market Value The theoretical price that a piece of property would bring if placed on the open market for a reasonable period of time, with a buyer willing (but not forced) to buy, and a seller willing (but not forced) to sell, if both buyer and seller were fully informed as to possible use of the land.

Marketable Title A title that is free and clear from undisclosed encumbrances or other defects that would expose a purchaser to litigation or impede a purchaser’s ability to enjoy the property or to later sell the property; required to be delivered by the seller to the purchaser at settlement. Also called Merchantable Title.

Master Deed A document that converts a parcel of land into a condominium regime. Also called Enabling Declaration, Declaration of Condominium, or Declaration Agreement.

Matched Pair Analysis Process of determining the value of specific property characteristics or features by comparing pairs of similar properties.
Material Breach An unexcused failure to perform according to the terms of a contract that are important enough to excuse the non-breaching party from performing her contractual obligations.

Material Fact A condition or occurrence that significantly and adversely affects the value of the real estate, reduces the structural integrity of improvements to real estate, or presents a significant health risk to occupants of the real estate; or information that indicates that a party to a transaction is not able to or does not intend to meet an obligation under a contract or agreement made concerning the transaction.

Materialman A person who supplies materials, equipment, or fuel for a construction project.

Measuring Life A person whose life determines the length of a life estate.

Mechanic’s Lien A specific lien claimed by someone who performed work on the property (construction, repairs, improvements, etc.) to secure the amount of the charges for services with interest and costs. This term is often used in a general sense, referring to broker’s liens or materialman’s liens as well as actual mechanic’s liens.

Meeting of the Minds When all parties involved agree to the terms of a contract. This is achieved through offer and acceptance. Also called Mutual Agreement or Mutual Consent.

Metes and Bounds System A legal description that starts at an easily identifiable point of beginning (POB), then describes the property’s boundaries in terms of courses (compass directions) and distances, ultimately returning to the point of beginning.

Millage A rate of taxation for real property calculated as $1 per $1,000 (or .001) of assessed value.

Mineral Rights Rights to the minerals located beneath the surface of the land.

Ministerial Act Tasks that a licensee may perform for a customer that are informative or clerical in nature and do not rise to the level of active agency representation.

Misrepresentation A false or misleading statement.

Mitigation Action taken by the non-breaching party to minimize the losses resulting from a breach of contract.

Mold A fungus that can release toxins into the environment causing allergic reactions in some people.

Monopoly A situation where only one or very few companies dominate the market share of a particular product or service.

Monument Any natural or man-made marker used to establish lines and boundaries in a metes and bounds survey. Also called Marker.

Mortgage A security instrument that creates a voluntary lien on real property to secure repayment of a debt.

Mortgage Banker A financial institution that usually originates and funds its own loans, which may then be sold on the secondary market. Also called Mortgage Banking Company.

Mortgage Broker A person who, for compensation, makes, negotiates, acquires, sells, or arranges for a mortgage loan.

Mortgage Contingency A clause in a contract that states the agreement is contingent on the buyer obtaining approval for a mortgage loan.

Mortgage Insurance Premium (MIP) The fee charged for FHA mortgage insurance coverage. The initial premium can be financed, and there is a monthly premium. Also called Upfront Mortgage Insurance Premium (UFMIP).

Mortgage Loan Originator A person who solicits, negotiates, explains, or finalizes the terms of a mortgage loan for residential real estate.

Mortgagee A lender who accepts a mortgage as security for the repayment of a loan.

Mortgagee’s Policy A type of title insurance that the lender may have drawn in its own name to protect its interests in the property. This policy is for the loan amount that’s outstanding at the time a claim would be paid.

Mortgagor A person who borrows money and gives a mortgage to the lender as security for repayment.

Mrs. Murphy Exemption—A nickname for the Fair Housing Act exemption for the rental of a unit or a room in an owner-occupied dwelling with four units or less. This exemption is provided only when rental advertising is not discriminatory, a real estate agent is not involved, and there is no discrimination based on race or color. Not recognized in all states.

Multiple Listing Service (MLS) A listing service whereby member brokers agree to share listings and commissions on properties sold jointly. The MLS generally consists of an online database that is updated regularly to include new listings.

-N-

National Do Not Call Registry National registry managed by the Federal Trade Commission that limits commercial telemarketers from phoning consumers who place their telephone numbers on a list.

Negative Amortization The effect when a loan balance grows because of deferred interest when payments are not covering the interest portion of the loan.

Negligence Conduct that falls below the standard of care that a reasonable person would exercise under the same circumstances; an unintentional breach of a legal duty resulting from carelessness, recklessness, or incompetence.

Negotiable Instrument A promissory note or other finance instrument that is freely transferrable.

Neighborhood A contiguous area labeled by similar traits or physical boundaries. Also called Market Area.
**Net Lease** A lease agreement that requires the lessee (tenant) to pay some of the operating expenses and other costs of the property in addition to paying the rent.

**Net Listing** A compensation strategy in which the seller sets a net amount that is acceptable for the property; if the actual selling price exceeds that amount, the broker is entitled to keep the excess as commission. Net listings are illegal in many states and discouraged in others.

**Net Operating Income (NOI)** Net income after all operating expenses have been deducted.

**Net to Seller** An estimate of the money a seller should receive from a real estate transaction based on a certain selling price after all costs and expenses have been paid. Also called Seller's Net.

**Net Zero Home** A home that produces as much energy as it consumes.

**Nonconforming Loan** Loan that does not meet Fannie Mae/Freddie Mac standards and, thus, cannot be sold on the secondary market.

**Nonconforming Use** Property use that doesn’t conform to current zoning laws, but is allowed because the property was being used that way before the new zoning law was passed. Also referred to as being “grandfathered in.”

**Nonexclusive Buyer Agency Agreement** An agreement between a buyer and any number of brokers where a broker earns a commission only if he is the one who introduces the buyer to the property she purchases.

**Non-homogeneity** A characteristic of real property; each piece of land, each building, and each house is a unique piece of real estate. Also called Uniqueness or Heterogeneity.

**Nonjudicial Foreclosure** Foreclosure by a trustee under the power of sale clause in a deed of trust without the involvement of a court; not used in all states.

**Nonmarital Property** Any property that was owned prior to the marriage or civil union or that was given or devised by will only to one spouse or legal partner during the term of the marriage or civil union.

**Nonpublic Personal Information** A consumer’s personal financial information that would not be easily obtainable by the general public, such as credit reports, bank accounts, transactions.

**Nonrecourse Loan** A loan in which the lender cannot collect the personal assets of the borrower or the borrower’s heirs when the collateral for the loan is sold for less than the amount owed on the loan.

**Notice of Foreclosure** The notification given by a lender to a borrower who has failed to repay a debt according to the terms of the loan, accelerating the due date of the debt to the present and requiring the borrower to repay the entire outstanding balance of the loan at once.

**Notice to Quit** A landlord’s notice to a tenant, demanding that he vacate the leased property. Also called Notice to Vacate.

**Novation** The substitution of a new contract for the original contract. Both parties must give their consent.

-O-

**Obedience** A fiduciary duty that requires a licensee to follow the (legal) instructions of the principal, obey the parameters of the agency relationship, and not stray beyond the scope of authority.

**Occupancy Standard** The establishment of the maximum number of occupants allowable in a given rental dwelling, intended to help promote an adequate and safely occupied inventory of housing.

**Offer** The first step in forming a contract when one party makes an offer to another party. An offer requires intent to contract and definite terms.

**Offer of Cooperation** Usually published in a multiple listing service that includes the amount (most frequently a percentage of the sales price or a flat fee) offered as compensation to another brokerage for participating in a property transaction, for example, as a selling agent, buyer’s agent, or leasing agent.

**Offeree** A person who receives an offer or to whom an offer is made.

**Offeror** A person who makes an offer.

**Open Listing** A nonexclusive listing, given by a seller to as many brokers as he chooses. If the property sells, only the broker who is the procuring cause is entitled to commission.

**Open Market Operations** When the Federal Reserve Board sells or buys government securities (or U.S. dollars) as a means of controlling supply and demand and confidence in those items.

**Operating Budget** A budget created to project the income and expenses for a property over a one-year period.

**Opt Out** A consumer’s right to terminate future electronic communication from business and commercial entities.

**Option to Purchase** A contract giving the optionee the right, but not the obligation, to buy property owned by the optionor at an agreed-upon price during a specified period.

**Optionee** A person to whom an option is given.

**Optionor** A person who gives an option.

**Order of Eviction** A court-ordered directive to a public officer (often the sheriff or marshal) to seize the property to regain possession for the owner.

**Origination** The process of making or initiating a new loan.

**Origination Fee** A fee charged by a lender to cover the administrative costs of making a loan, usually based on a percentage of the loan amount. See Point.

**Overage Rent** The amount above the base rent that a tenant owes according to the terms of a percentage lease. Also called Percentage Rent.
Owner’s Policy A type of title insurance issued in the name of the property owner. Coverage runs from the time of purchase for as long as the policyholder owns the property.

Ownership in Sevality Ownership by a single individual person or legal entity, as opposed to co-ownership. Also called Sole Ownership or Separate Property.

-P-

P.O.C. Any expenses associated with a real estate transaction that are paid outside of closing. Such payments should be noted on a settlement statement.

Package Mortgage A mortgage where personal property (e.g., appliances) is included in a real estate sale and financed with one contract.

Parcel A specific lot or piece of real estate, particularly a specified part of a larger tract.

Parol Evidence Evidence concerning negotiations or oral agreements that were not included in a written contract, altering or contradicting the terms of the written contract.

Partial Performance A potential remedy to breach of contract where the injured party agrees to accept less than the full terms of the original contract. Also called Accord and Satisfaction.

Partition, Judicial A court action to divide real property among its co-owners, so that each owns part of it in severalty, or (if it’s not practical to physically divide the property) each gets a share of the sale proceeds.

Partition, Voluntary When co-owners agree to terminate their co-ownership, dividing the property so each owns a piece of the property in severalty.

Pass-Through An additional operating cost that is passed from a property owner to a tenant, such as when property taxes go up.

Patent Defect A visible, apparent defect that can be seen in a reasonably thorough inspection of property.

Payment Cap A limit on the amount of mortgage payment increases that can occur with an adjustable rate mortgage.

Percentage Lease A lease for which the tenant’s rent is calculated as a percentage of the tenant’s sales.

Periodic Tenancy A leasehold estate that continues for successive periods of equal length (such as from week to week or month to month), until terminated by proper notice from either party. Also called Periodic Estate, Estate from Year to Year, or Period-to-Period Tenancy.

Permits Official government documents that acknowledge work a person wants to do on a property and allow it to be done.

Personal Property Tangible items that (usually) are not permanently attached to or part of real estate; any property that is not real property; movable property not affixed to land. Also called Chattel or Personality.

Pitch A roof’s vertical rise in inches, divided by its horizontal span in feet.

PITI A typical mortgage payment that includes Principal, Interest, Taxes, and Insurance. It would also include any homeowners association fees required as a condition of ownership.

Planned Unit Development (PUD) A type of subdivision in which developers do not have to comply with all standard zoning and subdivision regulations such as setback and lot size requirements.

Planning Board A local entity consisting of appointed members who hold public hearings, investigate solutions for the planning issues in the community, and make long-term recommendations; a planning board is also responsible for approving development projects in the community. Also called Planning Commission.

Plat A detailed survey map of a subdivision, recorded in the county where the land is located. Subdivided property is often called platted property. Also called Plat Map.

Platform Framing A technique of framing where a platform is built over the basement or crawl space, and then studs are extended up to the next level, where another platform is built; finally, studs are extended to the roof line.

Platted Property Land that has been subdivided into blocks and lots.

Plottage An increase in value, over the cost of acquiring the separate parcels, by successful assemblage, usually due to a change in use.

Point One percent of the loan amount. A fee charged by a lender for making a loan, calculated based on the loan amount.

Police Power The constitutional power of state and local governments to enact and enforce laws that protect the public’s health, safety, morals, and general welfare.

Porter’s Wage Escalation Formula Ties the rent escalation to the wages of the building’s cleaning and building maintenance personnel (called “porters”). The formula provides that tenants’ rent will increase a specific amount per square foot for a specified increase in the porter’s hourly wages.

Portfolio Lenders Financial institutions that make real estate loans that they keep and service in house instead of selling them on the secondary markets.

Possessory Interest An interest in property that entitles the holder to possess and occupy the property, now or in the future; an estate, which may be either a freehold or leasehold.

Power of Attorney An instrument authorizing one person (called an attorney-in-fact) to act as another’s agent, to the extent stated in the instrument.

Power of Sale Clause A clause that allows the trustee to sell trust deed property, without court supervision, when terms of the trust deed are not kept.
**Preapproval** The formal process by which a lender determines if potential borrowers can be financed through the lender, and for what amount of money. Preapproval is generally binding on the lender.

**Predatory Lending** Loan tactics that take advantage of ill-informed consumers through excessively high fees, misrepresented loan terms, or frequent refinancing that does not benefit the borrower.

**Preleasing** Signing leases with one or more commercial tenants prior to construction.

**Prelisting Inspection** A home inspection conducted for a homeowner before the owner puts the home on the market.

**Prepaid Expenses** Expense items on a settlement statement the seller has already paid in advance, usually at the beginning of a month for the rest of the month, or at the beginning of the year for the rest of the year or longer.

**Prepayment Clause** A contract clause that gives a lender the right to charge the borrower a penalty for paying off a loan early.

**Prepayment Penalty** Additional money charged by a lender for the borrower paying a loan off early. Not permitted for FHA-insured loans or VA-guaranteed loans.

**Prequalification** The informal process of determining how much a potential homebuyer might be eligible to borrow.

**Preselling Selling** Residential property prior to construction based on plans and/or model homes.

**Preventive Maintenance** Routine maintenance and inspections to keep equipment and the property in good working order.

**Price** The amount asked, offered, or paid for a property.

**Price-Fixing** An antitrust violation that occurs when two or more competitors agree to fix the prices that they will charge. In real estate it might occur when brokers agree with other brokers on commission rates; even the implication that brokers have discussed and/or reached agreement on fees could be illegal.

**Primary Market** A financial domain in which various entities—including banks and other financial institutions—produce and issue new securities, such as stocks, bonds, and mortgage loans.

**Prime Rate** The short-term interest rate a bank charges its most creditworthy customers.

**Principal** The sum of money loaned to a borrower; the outstanding balance of a loan.

**Principal Meridian** North-south lines designated and named throughout the country for use with the government survey system. They are based off the prime meridian, which is the line of longitude passing through the Royal Greenwich Observatory in England (0 degrees).

**Principle of Decreasing Returns** Theory that says that beyond a certain point, the added value of a feature, addition, repair, etc., is less than the actual cost of that item. Also called Principle of Diminishing Returns.

**Principle of Increasing Returns** The theory that the added value of an additional feature, addition, repair, etc., is more than the actual cost of the item.

**Private Mortgage Insurance (PMI)** Insurance offered by private companies to insure a lender against a borrower’s default on a loan.

**Private Restriction** A restriction imposed on property by a previous owner or the subdivision developer; a restrictive covenant or a condition in a deed.

**Probate** A judicial proceeding in which the validity of a will is established and the executor is authorized to distribute the estate property; when there is no valid will, a judicial proceeding in which an administrator is appointed to distribute the estate to heirs according to the laws of intestate succession.

**Procurement Fee** Compensation arrangement typically paid to a licensee by a tenant representative for finding space for the tenant. Procurement fees are often fixed fees but could be percentage-based.

**Procuring Cause** An uninterrupted series of events leading to the creation of a contract; the party whose efforts resulted in the creation of a binding contract for sale; for example, a broker whose efforts resulted in an executed contract, thus entitling her to a commission.

**Proforma Statement** A schedule of the projected income and expenses for a real estate investment over a given period.

**Progression** A principle that says the value of a smaller and less expensive home is positively affected when it is surrounded by larger and more expensive homes. Usually said about the “worst” home in the “best” area.

**Promissory Note** A financing instrument that evidences a promise to pay a specific amount of money to a specific person within a specific time frame. A written, legally binding promise to repay a debt.

**Property Inspection** An evaluation of the conditions of a property by a trained professional, often required by a lender before approval of a loan is granted. Inspections usually include looking for evidence of termites, structural integrity, septic systems, etc.

**Property Management Agreement** A written agreement that creates an agency relationship between the property owner/investor and the property manager.

**Property Management** Leasing or renting, or offering to lease or rent, real property of others for a fee, commission, compensation, or other valuable consideration pursuant to a property management employee contract.

**Property Manager** A person hired by a real property owner to administer, market, and maintain property, especially rental property.
Proprietary Lease An exclusive, longer-term lease given to a person who lives in and owns stock in a cooperative.

Pro-Rata Share The equitable distribution of expenses among tenants for the operating expenses of a building, generally based on the percentage of the property occupied by the tenant.

Proration The allocation of expenses between buyer and seller in proportion to their actual usage of the item or service.

Public Accommodation—An establishment that is intended to be available to everyone, either as a place of business or commerce or for federal, state, or local government business. It includes hotels, restaurants, retail, gas stations, theaters, museums, etc.

Puffing Superlative statements about the quality of a property that should not be considered assertions of fact.

Purchase Agreement A contract in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. Also called Purchase and Sale Agreement, Purchase Contract, Sales Contract, or Earnest Money Agreement.

Purchase Money Mortgage Generally describes a mortgage used to finance the purchase of real property; may specifically refer to a situation where the seller finances all or part of the sale price of real property for the buyer.

Quantity Survey Method A cost approach appraisal method where the appraiser counts the number and type of each part and material that were used to construct the building, plus adding a cost for labor, profit, permits, etc.

Quitclaim Deed A deed that grants any interest in property that the grantor may have without making any promises, including the promise that the grantor has any interest in the property being conveyed; often used to clear clouds on title.

Real Property The physical land and everything attached to it, and the rights of ownership (bundle of rights) in the real estate. Also called Realty.

REALTOR®—Any real estate licensee who is a member of the National Association of REALTORS® (NAR) and his or her affiliated state/local boards. Only members may use the term REALTOR® as it’s a registered trademark of NAR.

Reasonable Accommodation Any change or modification in the environment or the way things are customarily accomplished (e.g., rules, services, policies) that enables a qualified individual with a disability to enjoy equal opportunities.

Reasonable Modification A structural modification that is made to allow persons with disabilities the full enjoyment of the housing and related facilities.

Recital An element in a deed that identifies how and when the grantor took title to the property. Also called Source Clause.

Reconciliation The appraisal process of analyzing the values derived from the different appraisal approaches to arrive at a final value estimate or opinion.

Recording Fees Charges for filing documents at the county recorder’s office so that they become part of the public record.

Recourse Loan A loan in which, in the event of default, the lender can take action against the borrower personally in addition to foreclosing on the property.

Redlining When a lender refuses to make loans secured by property in a certain neighborhood because of the racial or ethnic composition of the neighborhood.

Referee’s Deed A deed issued by the court to a property buyer from a bankruptcy sale.

Referral For the purposes of RESPA, any oral or written action directed to a person that has the effect of affirmatively influencing the selection of a provider of a settlement service or business.
**Referral Fee** Consideration of any kind paid or demanded for the referral of a potential or actual buyer, seller, lessor, or lessee of real estate.

**Reformation** Changes or modifications to a contract by a court to reflect the true intention of the parties, such as to remedy a minor clerical error.

**Regression** A principle that says the value of a larger, more expensive home is negatively affected when it is surrounded by smaller, less expensive homes. Usually said about the “best” home in the “worst” area.

**Remainder** A future interest that becomes possessory when a life estate terminates, and that someone other than the grantor of the life estate holds.

**Remainderman** A person, other than the grantor, who has a future interest in the fee estate when a life estate ends. A remainder interest is inheritable.

**Remediation** The act of stopping or reversing something specific, often environmental damage.

**Rental Square Feet** The usable square feet plus a pro-rata portion of the common areas shared among all of the tenants, such as corridors, lobbies, and restrooms. This is the number typically used for calculating base rent. Also called Gross Square Feet.

**Renunciation** When someone who has been granted something or has accepted something later gives it up or rejects it; as when a broker withdraws from an agency relationship with a client.

**Replacement** Building the functional equivalent of the original building, using modern materials, usually the same size, layout, quality, and utility as the original.

**Reproduction** Building an exact duplicate of the original building, giving the new structure the exact same look and feel as the original.

**Rescission** The termination of a contract with each party giving anything acquired under the contract back to the other party (verb form is to rescind).

**Reserve Requirement** The percentage of customers’ deposits that commercial banks are required to keep on deposit, either on hand at the bank or in the bank’s own accounts; in other words, money the bank cannot lend to other people.

**Reserves** Cash on deposit or other highly liquid assets a borrower must have to cover two months of PITI mortgage payments, after they make the cash down payment and pay all closing costs.

**Reserves for Replacement** An amount of money, considered as an operating expense, set aside for future replacement of major items, such as the roof or heating system.

**Resident Manager** Represents a property management firm and may live on the premises of the building being managed.

**Residential Lead-Based Paint Hazard Reduction Act** A federal law that requires sellers and landlords to disclose known lead paint hazards for homes built before 1978.

**Residual Income** The amount of a borrower’s income remaining after subtracting taxes, housing expenses, and all recurring debts and obligations; a factor when qualifying prospective borrowers for VA-guaranteed loans.

**Restitution** The return of consideration by both parties when a contract is rescinded.

**Restrictive Covenant** A restriction on real property use imposed by a former owner; promise to do or not do an act relating to real property; usually an owner’s promise to not use property in a particular way. May or may not run with the land.

**Return on Investment (ROI)** The gain/profit an investor experiences from an investment relative to its cost to acquire.

**Reverse Mortgage** Allows qualified homeowners age 62 or older to convert equity in the home into a lump sum, a monthly cash stream, or a line of credit; becomes due when the last surviving borrower dies, sells the home, or ceases to live in the home for 12 consecutive months.

**Reversion** A future interest that becomes possessory when a temporary estate (such as a life estate) terminates, and that the grantor (or grantor’s successors in interest) holds.

**Reversioner** The person who has a future estate interest in reversion.

**Revocation** When someone who granted or offered something withdraws it; as when a principal withdraws the authority granted to an agent or an offeror withdraws the offer.

**Rider** An addition, amendment, or addendum to a document or contract.

**Right of Preemption** An option to be given the first chance to buy or lease property if the owner decides to sell or lease it after receiving a bona fide offer from a third party. Also called Right of First Refusal.

**Right of Rescission** The right of a consumer to rescind any credit transaction involving his or her principal residence as collateral (except first mortgages), lasting up to midnight of the third business day after the transaction.

**Right of Survivorship** A characteristic of statutory survivorship tenancy, joint tenancy, and tenancy by the entirety; surviving co-tenants automatically acquire a deceased co-tenant’s interest in the property.
Glossary

Right of Way (ROW) An easement giving the holder the right to cross another person's land.

Ringmen Individuals positioned among auction attendees to spot bidders for the auctioneer.

Riparian Rights Water rights of landowners whose land touches a natural body of water, such as a stream, a river, or an inland lake.

Risk The probability that events will not occur as expected.

Risk Management Identifying, managing, and minimizing the potential risks on the property.

Rough-ins Any type of interior work to a house or building that is not part of the finish work (e.g., plumbing, HVAC, electrical).

Roundtable Closing A settlement procedure conducted with all parties present.

Rule of Capture A legal principle that grants a landowner the right to all oil and gas produced by wells on his or her land, even if it migrated from underneath land belonging to another.

Runs with the Land Rights, conditions, or restrictions that are associated with the property as opposed to the individual who owns the property. They pass from owner to owner when the land is conveyed; an Appurtenance.

Salesperson Generically speaking, a real estate licensee who is associated with a licensed broker and as such may perform most of the acts a broker can on behalf of the broker. Also called Sales Associate.

Satisfaction of Lien The document a mortgagor gives the mortgage acknowledging the debt has been paid in full and the mortgage is no longer a lien against the property. Also called Discharge of Mortgage, Satisfaction of Mortgage, or Release of Lien.

Savings and Loan Association An institution whose primary function is to promote thrift and homeownership. All savings and loan associations must be chartered, either by the federal government or by the state in which they are located. Federally chartered savings and loan associations are owned by the depositors.

Scarcity A physical characteristic of real property that says there is a limited supply of real estate; the perceived supply of a good or service relative to the demand for the item.

Scraping Using or altering someone else's listing information for public consumption on another website.

Secondary Financing When a buyer borrows money from another source in addition to the primary lender to pay for part of the purchase price or closing costs; usually requires a subordination agreement.

Secondary Market A financial domain in which investors buy and sell securities—such as stocks, bonds, or mortgage loans—that were created in the primary market.

Section Part of a township, one-mile by one-mile square. Used for the rectangular survey system; one section equals 640 acres, 36 sections equal one township.

Section 203(b) FHA Loan The standard FHA-insured loan program. There are no income limits on this type of loan. The borrower must meet all FHA qualifying standards and the property cost must not exceed the maximum FHA mortgage amounts.

Securitization The act of pooling mortgages and then selling them as mortgage-backed securities.

Security Deposit Money a tenant gives a landlord at the beginning of the tenancy to ensure the tenant will comply with lease terms. The landlord may retain all or part of the deposit at the end of the tenancy to cover unpaid rent, repair costs, or other damages.

Seizin The possession of a freehold estate; ownership. Also spelled Seisin or Seizan.

Self-Dealing The conduct of a fiduciary that consists of taking advantage of his position in a transaction and acting in his own interests rather than in the interests of his clients.

Seller's Agent A licensee representing the interests of the seller of a property. Also called Listing Agent.

Seller's Market A situation in the housing market when a large number of buyers are looking for housing in an area of limited availability.

Serving The process of collecting loan payments, keeping records, and handling defaults.

Servient Tenant The owner of a servient tenant, that is, someone whose property is burdened by an easement.

Servient Tenement Property burdened by an easement; the owner of the servient tenement (the servient tenant) is required to allow someone who has an easement (the dominant tenant) to use his property.

Setback The legal distance that a building must be from a designated position such as a property line; determined by zoning requirements.
Settlement Officer The person charged with coordinating the activities and documentation necessary for completing a real estate transaction; usually the one who prepares the settlement statement and conducts the closing. Also called Closing Officer, Closing Agent, Escrow Agent, or Title Agent.

Settlement Services Any service provided in connection with a prospective or actual settlement of a real estate transaction, including, but not limited to, those provided by lenders, title companies, real estate brokers, property inspectors, attorneys, appraisers, etc.

Severable The concept that one part or provision of a contract that can be held unenforceable without making the entire contract unenforceable.

Severance A process through which fixtures are detached from the land and so revert back to personal property.

Share Loan A co-op loan signifying a buyer is purchasing shares in a corporation rather than a mortgage for ownership of property.

Sheathing A layer of boards or other wood or fiber materials applied to the outer studs, joists, and rafters to strengthen the structure and serve as a base for exterior weatherproof covering.

Sheriff's Deed A deed issued by the court to a property buyer from a foreclosure sale. Also called Master Commissioner's Deed.

Sheriff's Sale A foreclosure sale held after a judicial foreclosure. Sometimes called Execution Sale.

Short Sale A lender-approved sale from which the proceeds are not sufficient to cover the mortgage amount(s).

Site A parcel of land with enhancements, such as grading and utility installation, that make it ready for a building or structure.

Site Analysis An evaluation of the suitability of a specific parcel of land for a specific purpose.

Site Valuation The value of land with the enhancements necessary to make it ready for building, such as water, sewer, electricity, etc.

Situs A place where something exists; the exact position of a piece of property, giving it value.

Slab-on-Grade Construction A concrete foundation built directly on the ground.

Slander Defamation of another’s character or reputation through that which is spoken or heard.

Sloped Joist A roof construction with joists angled up from the outer load-bearing walls to the pitch of the roof allowing for vaulted ceilings.

Sole Proprietorship A business owned and managed by one person (or for tax purposes, legally married spouses) who is personally liable for all business debts. It could be organized under a fictitious or assumed name.

Spam The use of any electronic messaging system to send unsolicited bulk messages indiscriminately.

Special Agent An agent with limited authority to do a specific thing or conduct a specific transaction. Also called Limited Agent.

Special Assessment A tax levied only against properties that benefit from a public improvement (e.g., a sewer or street light) to cover the cost of the improvement; creates a special assessment lien (an involuntary, specific lien).

Specific Lien A lien that attaches only to a particular parcel of property.

Specific Performance Legal remedy in which a court orders someone who has breached a contract to perform as agreed, rather than paying monetary damages.

Specifications Written documents describing in detail the requirements for the scope of construction, including materials, standards, and expected quality of the finished structure. Also called Specs.

Spot Zoning The illegal rezoning of a single parcel or a small area to benefit one or more property owners rather than carry out the objectives of the master plan.

Square Foot Method A cost approach appraisal method for determining the cost of a building, relying on cost manuals.

Stable Monthly Income Income that can reasonably be expected to continue in the future.

Stakeholder Someone with a stake or interest in a project.

Statute of Frauds A state law that requires certain types of contracts to be in writing and signed to be enforced.

Statute of Limitations A law requiring parties to file a particular type of lawsuit within a specified time after the event giving rise to the suit occurred.

Statutory Nonemployee A real estate licensee who is treated as an independent contractor for tax purposes when specified conditions are met: proper licensing; compensation based on sales; and services performed under written contract.

Statutory Right of Redemption Allows a mortgagor (debtor) to redeem property for a set timeframe after a foreclosure sale, regardless of the timing of other events. Time frames vary by state; not available in all states.

Statutory Right of Reinstatement A way for borrowers to cure the default by bringing the mortgage current—including all accumulated costs and fees—between the time they receive a notice of foreclosure and the time a foreclosure action is filed.

Statutory Year A year based on a monthly rate that considers each month to be 30 days. There are 360 days in a statutory year. Also called Banker's Year.

Steering Channeling prospective buyers or tenants to particular neighborhoods based on their race or membership in another protected class.
**Glossary**

**Stigmatized Property** A property that is undesirable to most people because of a past event, such as a crime or death. Such stigmas as not considered material facts that must be disclosed.

**Straight Loan** A non-amortized loan in which the regular payments cover only the interest over the term of the loan. Sometimes called **Bullet Loan.**

**Straight-Line Depreciation** Simple depreciation method that takes the total cost of a building and divides that by the number of years the building is expected to be useful.

**Straw Buyer** A person who receives payment from a conspirator for the use of that person's name and credit history to apply for a loan, generally as part of a mortgage fraud scheme. Also called **Straw Owner or Straw Purchaser.**

**Strict Foreclosure** A foreclosure action where the court establishes a date by which the borrower must pay the balance in full; once the deadline passes, the lender is awarded title to the property. This type of foreclosure is uncommon.

**Stud** A vertical beam that serves to frame a structure (also known as a wood-framing member).

**Subagent** A real estate licensee who acts as a representative of his or her broker’s client, providing the same duties and responsibilities of that broker.

**Subject Property** Property for which a value estimate is sought. Also called **Base.**

**Subordination Agreement** A written agreement between lienholders on a property that changes the priority of mortgages, judgments, and other liens.

**Subprime Loan** Loan that has more risks than allowed in the conforming market. Also called **B-C Loans or B-C Credit.**

**Substantial Performance** When a promisor doesn't perform all of his contractual obligation but does enough so that the promisee is required to fulfill her part of the deal.

**Substitution** A principle that says an informed buyer will not pay more for a property, or a feature in a property, than a comparable substitute.

**Subsurface Rights** The implication that an owner of land has rights to the land below the surface to the center of the earth, even though this part is not documented.

**Suit to Quiet Title** A lawsuit to determine who has title to a piece of property, or to remove a cloud from the title. Also called **Quiet Title Action.**

**Superfund Amendments and Reauthorization Act (SARA)** An act that amended CERCLA, designated more money to the Superfund trust, and established new environmental laws and regulations.

**Supply and Demand** An economic principle that says that for all products, goods, and services when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise.

**Survey** The formal process of locating and measuring the boundaries of a property and identifying the improvements, encroachments, and easements that are associated with that parcel.

**SWOT Approach** A planning technique that identifies and examines strengths, weaknesses, opportunities, and threats.

**Syndicate** An association of people or entities formed to operate an investment business. A syndicate is not a recognized legal entity; it can be organized as a corporation, partnership, or trust. Also called **syndication.**

**Tacking** Successive periods of use or possession by more than one person that are added together to equal the number of years required under state law for easement by prescription or adverse possession.

**Takeout Loan** A loan that provides permanent financing after construction is complete.

**Taking** The government’s unconstitutional condemnation of private property for public use without just compensation.

**Tax Depreciation** The expensing of the cost of business or investment property over a set number of years, determined by the IRS to be an asset’s useful life (27 1/2 years for residential property; 39 years for non-residential property).

**Tax Shelter** Property or other investments that give owners certain income tax advantages, such as deductions for property taxes, mortgage interest, and depreciation.

**Technically Exhaustive Inspection** An inspection that involves extensive measurements and testing, such as measuring and testing loads in the electrical system, pressurizing the water and drainage systems and measuring flow rate, etc., which is beyond the scope of a normal home inspection.

**Tenancy at Sufferance** Possession of property by a tenant who once had a valid lease, but stays on after the lease expires without the landlord’s permission. Also called **Estate at Sufferance.**

**Tenancy at Will** When a tenant is in possession with the owner’s permission, but with no definite lease term and no rent being paid (or rent is not paid on a regular basis); e.g., a landlord lets a holdover tenant remain on the premises without paying rent until the landlord finds a new tenant. Also called **Estate at Will.**

**Tenancy by Entirety** A form of property co-ownership by legally married spouses, in which each spouse has an undivided one-half interest without the other’s consent.

**Tenancy in Common** A form of co-ownership in which two or more persons each have an undivided interest in the entire property (unity of possession), but no right of survivorship.

**Tenant** Someone in lawful possession of real property, especially, someone who has leased property from the owner.
Tendering Performance An unconditional offer by one party to perform his part of a contract. Also called Tender.

Testate Refers to someone who has died and left a will.

Tester A person working with a fair housing organization who pretends to be interested in buying or renting property from someone suspected of unlawful discrimination. Also called Checker.

Tie-In Agreement An antitrust violation in which one transaction or agreement is contingent on a second transaction or agreement. Also called Tying Agreement.

Time is of the Essence A clause added to a contract that voids the contract when the deadline passes. The party that fails to perform by the deadline is in material breach of the contract.

Timeshare A form of property ownership in which several buyers purchase interests in real estate, generally as tenants in common, with each party having the right to use the property and facilities for a designated period of time.

Title The actual, lawful ownership interest in a property; title is not a document but a concept.

Title Insurance Insurance policy that protects lenders and homeowners against losses resulting from undiscovered title defects and encumbrances.

Title Report A report issued by a title company disclosing the condition of the title to a specific piece of property; evidence of marketable title.

Title Search An inspection of the public record to determine all rights and encumbrances affecting title to a piece of property.

Title Theory State State in which a mortgagee holds actual title to property until the loan is repaid.

Tortious Interference The causing of harm by disrupting something that belongs to someone else, for example, interfering with a contractual relationship so that one party fails to execute her promise.

Townhome Property developed for co-ownership where each co-owner has a separate fee simple interest in an individual unit, including its roof and basement, as well as the land directly beneath the unit, and an undivided interest in the common areas of the property.

Township Square division of land, six miles by six miles, in the rectangular survey system. One township contains 36 sections.

Township Line East-west lines that run parallel to baselines in the rectangular survey system.

Township Tier The six-mile distance between township lines in the rectangular survey system.

Trade Fixtures Items of personal property that are annexed to leased property, are necessary to a trade or business, and are removable by the tenant prior to the expiration of the lease.

Traditional Agency An agency relationship where the seller is the only client and the buyer has no representation.

Transaction Brokerage A brokerage relationship in which a licensee provides only administrative services to buyers and sellers to assist in a transaction, remaining neutral and having no fiduciary responsibility toward either party. Also called Facilitational Brokerage, Transaction Broker, or Non-Agency.

Transfer Tax A tax levied on the transfer of a piece of real property from one person to another; it could be levied by the state, the county, or the municipality.

TRID Rule The TILA-RESPA Integrated Disclosure rule, issued by the Consumer Financial Protection Bureau to create standardized, consumer-friendly disclosure documents, including the Loan Estimate and the Closing Disclosure.

Trigger Term A word or phrase that describes a loan, including the down payment, terms, and monthly payment. If an ad uses a trigger phrase, disclosures are needed to tell everything about the loan. Also called Trigger Phrase.

Triple Net Lease A lease in which the tenant pays all the expenses associated with the owning the property, in addition to paying the rent. Also called Net-Net-Net.

Trusses A framework of rafters, posts, and beams that forms the support for a roof.

Trust A legal arrangement in which title to property (or funds) is vested in one or more trustees who manage the property (or invest the funds) on behalf of the trust's beneficiaries, in accordance with instructions set forth in the document establishing the trust.

Trustee A person appointed to manage a trust on behalf of the beneficiaries; in a trust deed, an independent third party that holds the trust instrument.

Trustor The property owner who grants a trust to a third party for the benefit of someone else.

Truth in Lending Act (TILA) Federal law that requires disclosure of the terms of credit by a creditor to a prospective borrower. Implemented by Regulation Z, which is under the oversight of the Consumer Financial Protection Bureau.

Underground Storage Tank (UST) A receptacle, at least 10% of which is underground, used to store a variety of substances such as heating oil, gasoline, chemicals, and hazardous waste; an environmental hazard due to corrosion, spills, leaks, and overfills. Regulated by the EPA.

Underwater A home purchase loan that has a higher balance than the market value of the property. Being underwater may limit the homeowner’s options for refinancing and will prevent the homeowner from selling the property without having the assets to pay the difference needed to pay off the loan.
Underwriter Individual who evaluates a loan application to determine its risk level for a lender or investor; final decision maker on a loan application.

Underwriting The process of evaluating and deciding whether to make a new loan and on what terms.

Undisclosed Dual Agency A situation where one licensee represents both buyer and seller in a single transaction without the informed consent of both parties; very often may be practiced unintentionally, possibly by implying to one party that he is represented when, in fact, there is no agency agreement.

Undivided Interest A co-tenant’s interest, giving him the right to possession of the whole property, rather than a particular section of it.

Unenforceable Contract A contract that a court would refuse to enforce. Some oral contracts or vaguely worded contracts could be deemed unenforceable.

Uniform Commercial Code (UCC) A general set of laws adopted by most states with the purpose of providing uniformity and fairness in commercial transactions, including the sale and financing of personal property.

Uniform Residential Appraisal Report (URAR) A standard appraisal report form used by lenders and appraisers because it has been developed and approved by secondary mortgage market players Fannie Mae and Freddie Mac.

Uniform Residential Loan Application A standardized form from Fannie Mae or Freddie Mac that lenders require potential borrowers to complete with pertinent information about the borrower and the property.

Uniform Standards of Professional Appraisal Practice (USPAP) Professional appraisal standards developed by The Appraisal Foundation, and now recognized throughout the United States as accepted standards of appraisal practice.

Unilateral Contract A contract in which only one party is legally bound.

Uniqueness A characteristic of real property; each piece of land, each building, and each house is a unique piece of real estate. Also called Non-homogeneity or Heterogeneity.

Unit-in-Place Method A cost approach appraisal method for determining the cost of a building that estimates the cost of reproducing a building by looking at the unit cost of each of the component parts of the structure, and adding all of these unit costs together.

Unity of Interest Each co-owner having an equal interest (equal share of ownership) in a piece of property.

Unity of Person Both co-owners considered to be a single legal entity. Applies only to married couples and is necessary for tenancy by the entirety.

Unity of Possession Each co-owner being equally entitled to possession of the entire property because the ownership interests are undivided.

Unity of Time Each co-owner acquiring title at the same time.

Unity of Title Each co-owner acquiring title through the same instrument (deed, will, or court order).

Universal Agent An agent authorized to do everything that can be lawfully delegated to a representative.

Urban Design Design that addresses both the appearance and the function of buildings, streets, sidewalks, open spaces, and other features.

Urban Planning The process of creating a blueprint to guide the future development of a community.

Urea-Formaldehyde A potentially toxic chemical used in manufacturing building materials such as particleboard, plywood paneling, carpeting, and insulation.

Urea-Formaldehyde Foam Insulation (UFFI) A type of insulation that can be blown in or injected behind walls and other areas that are hard to access.

Usable Square Feet The space actually available and usable for a tenant’s personnel, furniture, and equipment. The actual floor space inside the exterior walls of leased premises. Space the tenant can physically use inclusive of interior walls and columns. Also called Net Square Feet.

Use Variance Allows landowners to use their land in a way that is not permitted under current zoning laws, such as commercial use in a residential zone.

Usury Charging a higher interest rate than the law allows.

- V -

VA-Guaranteed Loan A mortgage loan made by lenders to eligible veterans that is guaranteed by the Department of Veteran’s Affairs, protecting the lender up to specified dollar amounts.

Valid Contract A binding, legally enforceable contract. It meets all of the legal requirements for contract formation.

Value The monetary relationship between properties and those who buy, sell, or use those properties.

Vapor Retarder A material that is used to reduce the flow of water vapor.

Variable Expense Operating expense necessary to the property, but dependent on the property’s occupancy level.

Variable Expenses Operating expenses necessary to the property, but dependent on the property’s occupancy level.

Variance A permit obtained from the local zoning authority allowing the holder to use property or build a structure in a way that deviates from strict compliance with a zoning ordinance.

Vendee The buyer in a land contract.

Vendor The seller in a land contract.

Ventilation A system that draws fresh air into a structure and removes moist, stale air.

Verification of Deposit (VOD) A form sent by a bank directly to a lender verifying the borrower’s accounts.
Vicarious Liability Liability that is created because of the relationship between someone and the actions of the person who is actually liable, such as a broker who has vicarious liability for the actions of her affiliated agents even though the broker may have done nothing wrong.

View Easement A negative easement that prevents a servient tenant from adding anything to their property that would affect the quality of the dominant tenant’s view. Also called Easement for Light and Air.

Visual Preference Survey A type of survey in which respondents are asked to evaluate various design options as depicted in drawings, photographs, or other visual representations.

Void Contract A contract that isn’t enforceable because it lacks one or more of the requirements for contract formation or is otherwise defective.

Voidable Contract A contract that one of the parties can end without liability because of a lack of legal capacity or other factors such as fraud or duress.

Voltage A measure of electric potential; the energy that could be released if the electric current is allowed to flow.

Voluntary Alienation When title to property is transferred voluntarily through a sale, gift, dedication, or grant.

Voluntary Lien A lien placed against property with the consent of the owner, e.g., a mortgage or deed of trust.

Warranty Deed A deed in which the grantor fully warrants good and clear title to the property and agrees to defend the premises against the lawful claims of third parties.

Warranty Forever A guarantee in a deed that the grantor promises to compensate the buyer if title is not good.

Waste The actions of a life tenant who uses the property in a way that damages it or reduces its market value.

Wetlands An ecosystem where the land is permeated with water, which either lies on or near the surface of the land; an environment where specialized plants, aquatic species, and wildlife live.

Wraparound Mortgage A financing arrangement in which an existing loan on a property is retained while the lender gives the borrower another, larger loan.

Yield Spread Premium (YSP) A tool that mortgage brokers can use to lower the upfront closing costs for a borrower.

Zoning Government regulation of the uses of property within specified areas.

Zoning Ordinance Local laws that divide a city or county into different areas or zones. These zones determine how land can be used, subdivided, or improved along with the specific requirements for compliance.
Appendix

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Challenge Activities

Chapter 1: Introduction to Real Estate

1=E; 2=P; 3=S; 4=E; 5=S; 6=E, G; 7=E, S; 8=G; 9=S; 10=P; 11=P; 12=E, G; 13=S; 14=E; 15=S

Chapter 2: Real Property Fundamentals

1=R; 2=R; 3=R; 4=P; 5=R; 6=P; 7=R; 8=R; 9=R; 10=R; 11=P; 12=R; 13=P; 14=P; 15=P

Chapter 3: Possessory Interests in Real Property

Fee simple defeasible (“as long as”). The property would automatically revert to P or P’s heirs if M opened a bar on the property.

1=Tenancy at will; 2=Tenancy for years; 3=Periodic tenancy; 4=Tenancy at sufferance; 5=Tenancy at will; 6=Periodic tenancy

Chapter 4: Nonpossessory Interests in Real Property

(A) Mortgage Lien=voluntary and specific; third position.
(B) Property Tax Lien=involuntary and specific; first position.
(C) Mechanic’s/Materialman’s Lien=involuntary and specific; second position.
(D) Income Tax Lien=involuntary and general; fourth position.
(E) Judgement Lien=involuntary and general; fifth position.

Chapter 5: Forms of Ownership

1=P; 2=Q; 3=A; 4=H; 5=C; 6=K; 7=D; 8=N; 9=F; 10=G; 11=L; 12=I; 13=O; 14=E; 15=B; 16=J; 17=M

Chapter 6: Title Transfer and the Public Records

1=C; 2=A; 3=F; 4=J; 5=L; 6=D; 7=N; 8=G; 9=B; 10=O; 11=I; 12=M; 13=H; 14=Q; 15=P; 16=E; 17=K

Chapter 7: Describing Real Property

1. 80 acres
2. 40 acres
3. 20 acres
4. SW ¼; 160 acres
5. SE ¼, NW ¼; 40 acres
6. NW ¼, SE ¼, SE ¼; 10 acres

Chapter 8: Agency Fundamentals

Does breach: 3, 4, 7, 8

Does NOT breach: 1, 2, 5, 6, 9, 10

Chapter 9: Real Estate Brokerage

1. 6.5% (0.065) x $234,500 = $15,242.50 commission earned.
2. $54,000 ÷ $1,200,000 = 0.045 or 4.5% commission rate.
3. $38,137.50 ÷ 0.0675 (6.75%) = $565,000 sales price.
4. Commission: 0.06 x $90,000 = $5,400. $5,400 ÷ 2 = $2,700 to each brokerage.
5. Total commission: $7,420 x 2 = $14,840. $14,840 ÷ $237,440 = 0.0625 or 6.25% commission rate.
6. Commission: $300,000 x 0.06 = $18,000 and $124,600 x 0.07 = $8,722. Total commission: $18,000 + $8,722 = $26,722. $26,722 x 0.60 = $16,033.20 commission earned by selling agent.
7. Total commission: $390,000 x 0.06 = $23,400. $23,400 ÷ 2 = $11,700 earned by the selling brokerage. $11,700 x 0.70 = $8,190 earned by the selling agent.

8. Total commission on the sale; $426,000 x 0.07 = $29,820. Agent B earns 70% of the total commission: 40% + (60% ÷ 2): $29,820 x 0.7 = $20,874 commission earned.

Chapter 10: Federal Fair Housing

1. Yes (marital status and familial status). Some can interpret this to mean that single people or married couples with children are not welcome. “Starter Homes” or “First Time Home Buyers” may be a better choice to avoid discrimination claims.

2. No (disabled). Fair housing laws do not prohibit advertising that a feature exists. To advertise the wheelchair ramp does not exclude anyone from the housing.

3. Yes (national origin, ancestry). Such an ad could imply that “certain people,” whoever they might be, are not welcome. It’s better to describe the community. If it’s gated, for example, that could be included in an advertisement.

4. Maybe (age). It depends on whether the property meets the Fair Housing exemptions for housing for older persons. If so, it would be best to provide that detail in the ad, if possible.

5. Maybe (sex). As long as the roommate is in a property where living space is shared, as opposed to a multi-unit building, advertising for someone of a particular sex is not prohibited.

6. Yes (religion). While a geographical reference may seem innocent, this may be interpreted as recruiting persons of a particular religion at the exclusion of other faiths. Mentioning the walking distance to shopping or transportation, for example, would not be a problem since it does not favor one group of consumers over another.

7. Maybe (national origin, ancestry). It might seem reasonable in markets with large numbers of people of a specific ethnicity to run advertisements in local newspapers in a foreign language. If an advertisement is published in a non-English language, however, it is advisable to include an English translation or run the same ad in an English language newspaper to avoid charges of targeting a particular ethnic group or charges of illegal steering.

8. Maybe (familial status). Mentioning a playground could imply that families with children are preferred. It might be better to indicate that a “park” is nearby.

9. No. As long as a credit check is required of every prospective tenant, there’s nothing illegal about advertising this condition. While the source of income may be protected (by the Equal Credit Opportunity Act, covered in a later chapter), credit-worthiness is not.

10. No. It might seem as though this fact included in an ad is a violation, but if it is simply a factual description of the property, it would not be a violation.

Chapter 11: Contract Fundamentals


Chapter 12: Real Estate Contracts

Generally required elements: 3, 4, 8, 9, 11, 13, 15

Chapter 13: Financing Principles

1. $229,697.50 balance x 0.045 interest rate = $10,336.39 annual interest

2. $10,336.39 annual interest rate ÷ 12 months = $861.37 interest/month

3. $1,165 monthly P&I payment - 861.37 interest = $303.63 applied to principal
4. $229,697.50 balance - $303.63 principal reduction  
   = $229,393.87 new balance

5. First, determine the annual interest by multiplying the interest payment by 12 months: 
   $865.00 x 12 months = $10,380. Next, divide the 
   annual interest by the interest rate of 4.75% to 
   find the balance of the loan before the borrower 
   submitted this month’s payment: $10,380 ÷ 
   0.0475 = $218,526.31.

6. First, find the annual interest by multiplying the 
   monthly interest by 12: $297.50 x 12 months = $3,570. Then divide the annual interest by the 
   current balance on the loan to find the interest 
   rate: $3,570 ÷ $42,000 = 0.085, or 8.5%.

### Chapter 16: Real Property Appraisal

<table>
<thead>
<tr>
<th>Subject Property</th>
<th>Comparable 1</th>
<th>Comparable 2</th>
<th>Comparable 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$288,000</td>
<td>$301,000</td>
<td>$290,000</td>
</tr>
<tr>
<td>Bedrooms</td>
<td>4 bedrooms</td>
<td>4 bedrooms</td>
<td>5 bedrooms</td>
</tr>
<tr>
<td>Adjustment</td>
<td>--</td>
<td>--</td>
<td>- $4,000</td>
</tr>
<tr>
<td>Full Baths</td>
<td>2 full baths</td>
<td>2 full baths</td>
<td>3 full baths</td>
</tr>
<tr>
<td>Adjustment</td>
<td>--</td>
<td>--</td>
<td>- $1,500</td>
</tr>
<tr>
<td>1/2 Baths</td>
<td>1 half bath</td>
<td>2 half baths</td>
<td>1 half bath</td>
</tr>
<tr>
<td>Adjustment</td>
<td>--</td>
<td>- $800</td>
<td>--</td>
</tr>
<tr>
<td>Exterior</td>
<td>Brick</td>
<td>Vinyl Siding</td>
<td>Brick</td>
</tr>
<tr>
<td>Adjustment</td>
<td>--</td>
<td>+ $7,500</td>
<td>--</td>
</tr>
<tr>
<td>TOTAL</td>
<td>+ $6,700</td>
<td>- $5,500</td>
<td>+ $4,700</td>
</tr>
<tr>
<td>Indicated Value</td>
<td>$294,700</td>
<td>$295,500</td>
<td>$294,700</td>
</tr>
</tbody>
</table>

### Chapter 17: Land Use and Environmental Issues

1=B; 2=D; 3=I; 4=F; 5=G; 6=J; 7=A; 8=C; 9=H; 10=E
### Chapter 18: Closing Real Estate Transactions

#### A: Buyer's Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Sales Price</td>
<td>$200,000.00</td>
</tr>
<tr>
<td>Buyer Paid at Closing</td>
<td></td>
</tr>
<tr>
<td>Settlement Charges</td>
<td>$8,000.00</td>
</tr>
<tr>
<td>Mortgage Interest</td>
<td>$170.00</td>
</tr>
<tr>
<td>Seller Paid in Advance</td>
<td></td>
</tr>
<tr>
<td>Fuel Oil</td>
<td>$585.00</td>
</tr>
<tr>
<td>HOA Fees</td>
<td>$318.00</td>
</tr>
<tr>
<td>Gross Amount From Borrower</td>
<td>$209,073.00</td>
</tr>
<tr>
<td>Earnest Money Deposit</td>
<td>$10,000.00</td>
</tr>
<tr>
<td>New Mortgage Loan</td>
<td>$170,000.00</td>
</tr>
<tr>
<td>Adjustments Unpaid by Seller</td>
<td></td>
</tr>
<tr>
<td>Property Tax (1/1 – 7/21)</td>
<td>$1,909.50</td>
</tr>
<tr>
<td>Total Paid By/For Borrower</td>
<td>$181,909.50</td>
</tr>
<tr>
<td>Cash From/To Borrower</td>
<td></td>
</tr>
<tr>
<td>Gross Amount Due From Borrower</td>
<td>$209,073.00</td>
</tr>
<tr>
<td>Less Amount Paid By/For Borrower</td>
<td>$181,909.50</td>
</tr>
<tr>
<td><strong>Cash X To From</strong></td>
<td><strong>Borrower</strong></td>
</tr>
</tbody>
</table>

- **Mortgage Interest:** (1) $200,000 x 0.85 = $170,000 loan. (2) $170,000 = 0.04 = $6,800 annual interest. (3) $6,800 ÷ 360 = $18.8888/day. (4) July 22 to July 30 = 9 days (remember, we’re using a 360-day calendar, so only 30 days per month). (5) 9 x $18.8888 = $169.9992 or $170 debit buyer.

- **Fuel Oil:** $780 x 0.75 = $585 credit seller/debit buyer.

- **HOA Fees:** (1) $360/half year x 2 = $720/year. (2) $720 ÷ 360 = $2/day. (3) August to December is 150 days (30 days x 5 months) + 9 days in July = 159 days. (4) 159 x $2 = $318 credit seller/debit buyer.

- **Property Tax:** (1) $3,420 ÷ 360 days = $9.50/day. (2) January to June = 180 days (6 months) + 21 days in July = 201 days. 201 days x $9.50 per day = $1,909.50 credit buyer/debit seller.

#### B: Seller's Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Sales Price</td>
<td>$200,000.00</td>
</tr>
<tr>
<td>Seller Paid in Advance</td>
<td></td>
</tr>
<tr>
<td>Fuel Oil</td>
<td>$585.00</td>
</tr>
<tr>
<td>HOA Fees</td>
<td>$318.00</td>
</tr>
<tr>
<td>Gross Amount Due Seller</td>
<td>$200,903.00</td>
</tr>
<tr>
<td>Reductions in Total Due Seller</td>
<td></td>
</tr>
<tr>
<td>Settlement Charges</td>
<td>$15,200.00</td>
</tr>
<tr>
<td>Existing Mortgage Payoff</td>
<td>$95,000.00</td>
</tr>
<tr>
<td>Adjustments Unpaid by Seller</td>
<td></td>
</tr>
<tr>
<td>Property Tax (1/1 – 7/21)</td>
<td>$1,909.50</td>
</tr>
<tr>
<td>Total Reduction Due Seller</td>
<td>$112,109.50</td>
</tr>
<tr>
<td>Cash From/To Seller</td>
<td></td>
</tr>
<tr>
<td>Gross Amount Due To Seller</td>
<td>$200,903.00</td>
</tr>
<tr>
<td>Less Reductions Due Seller</td>
<td>$112,109.50</td>
</tr>
<tr>
<td><strong>Cash X To From</strong></td>
<td><strong>Seller</strong></td>
</tr>
</tbody>
</table>
Chapter 19: Taxation and Investment

1. Choose the correct tax formula: Percent (Tax Rate) \( \times \) Whole (Assessed Value) = Part (Property Taxes). First convert 12 mills to 0.012, then insert the values known and calculate. \( 0.012 \times 318,750 = 3,825 \) in annual taxes.

2. Choose the correct tax formula: Part (Property Taxes) \( \div \) Percent (Tax Rate) = Whole (Assessed Value). First, to convert mills, move the decimal point three places to the left then substitute numbers for the known factors in the formula: \( 1,800 \div 0.072 = 25,000 \), which is the assessed value of the property.

3. Choose the correct formula: Part (Property Taxes) \( \div \) Whole (Assessed Value) = Percent (Tax Rate) and plug in the known values: \( 8,200 \div 148,900 = 0.055 \). The tax rate used is 55 mills, \$5.50 per \$100 of value, \$55 per \$1,000 of value, or 5.5%.

4. First, determine the assessed value: \( 580,000 \times 0.40 = 232,000 \). Next, choose the correct tax formula: (Property Taxes) \( \div \) Whole (Assessed Value) = Percent (Tax Rate). Plug in the known numbers: \( 6,496 \div 232,000 = 0.028 \). This equates to a tax rate of 28 mills, \$2.80 per \$100 of value, or 2.8%.

5. First, calculate the assessed value: \( 175,000 \times 0.50 = 87,500 \). Next, determine the number of taxing units: \( 87,500 \div 1,000 = 87.5 \) taxing units. Next, find the annual taxes using the correct tax formula: Percent (Tax Rate) \( \times \) Whole (Assessed Value based on taxing units) = Part (Property Taxes). Plug in the known values: \( 65 \times 87.5 = 5,687.50 \) annual taxes. Finally, divide by two to find semi-annual taxes: \( 5,687.50 \div 2 = 2,843.75 \) semi-annual taxes.

6. First, find the assessed value using the correct tax formula: Part (Property Taxes) \( \div \) Percent (Tax Rate) = Whole (Assessed Value). Plug in the known variables: \( 2,120 \div 47 \text{ mills (0.047)} = 45,106 \). The question asks for market value, so divide the assessed value by the assessment rate of 35%: \( 45,106 \div 0.35 = 128,874 \) market value.

Chapter 20: Professional Ethics

1. No; simply advertising the rate to the consumer is not a violation. Since the broker is not consulting with any competing broker to set a commission rate, there is no restraint of trade.

2. Yes; The decision by competing brokerages to not do business with XYZ inhibits possible sales to XYZ’s agents. This is an example of group boycotting.

3. Yes, such a discussion of commission rates could be considered an unreasonable restraint of trade and, therefore, price-fixing.

4. Yes, here S is attempting to tie the listing agreement to the services offered by the staging company. This is an example of a tie-in agreement.

5. Yes, this could be an example of disparagement, especially considering the fact that the licensees at High Street might have been doing business in the area for years, just like F.

6. No, this conversation took place among agents of the same brokerage, not competing brokerages, so it is not an antitrust violation.

7. Yes, even if the agreement seems logical given the neighborhood of each a broker, such an arrangement could be considered market allocation that might result in a restraint on trade because it limits the choices of the consumer.

8. Yes, the MLS represents members from various brokerages. A refusal to deal with a specific party could be considered group boycotting.

9. Yes, although T did not specifically conspire with other brokerages on the commission rate, the mere discussion of prices has been determined to be an example of price-fixing.

10. Yes, transaction 1, the purchase of the condo, is tied to transaction 2, a listing. This could be an example of an illegal tie-in arrangement.

Chapter 21: Property Management

1=A; 2=F; 3=B; 4=H; 5=G; 6=I; 7=D; 8=J; 9=E; 10=C
**Chapter 22: Introduction to Commercial Real Estate**

1. Most of these issues will likely factor into his decision with three exceptions: The proximity to distribution channels is more likely to be of interest to a warehouse/industrial tenant. The topography is more likely to be an issue for vacant land ready for development. Community opposition is more likely to be a concern for an industrial tenant than a coffee shop.

2. The annual base rent is $25,200 ($2,100 monthly rent x 12 months = $25,200).

3. To find the natural breakpoint, divide the annual base rent by the agreed-upon overage percentage ($25,200 / 0.06 = $420,000).

4. If he doesn't earn more than the breakpoint, he only owes the base rent of $25,200.

5. He has to pay a 6% overage percentage on the $15,000 he earns over the breakpoint ($15,000 x 0.06 = $900). Adding that $900 to the $25,200 base rent equals $26,100 total.

**Chapter 23: Residential Construction and Home Inspection**

No Challenge Activity.

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**CHAPTER QUIZZES**

**Chapter 1: Introduction to Real Estate**

1. B. A person must have a broker-dealer license in order to sell securities. A real estate licensee could be involved in the sale of commercial property, timeshares, and vacant land on behalf of a client.

2. D. Buying and selling single-family homes is the typical entry-level position in real estate.

3. B. An independent contractor is paid commission for finding a ready, willing, and able buyer. It doesn’t matter how many hours he or she works to do so.

4. A. A real estate licensee would have a fiduciary relationship with clients regardless of whether he is an employee of his broker or an independent contractor.

5. B. An independent contractor receives a 1099-MISC form detailing any commission-based income.

6. C. An employer does not withhold property tax from an employee's paycheck.

7. B. As a licensed salesperson, I can accept compensation only from his broker, never from a member of the public.

8. D. A career in sales is less likely to result in a predictable income, although the other choices are advantages.

9. C. A person can use the term REALTOR® only after becoming a member of the National Association of REALTORS®. Using this professional designation without NAR membership is a violation of trademark law. Remember, also, that if a person’s sponsoring broker is an NAR member, the licensee must also join.

10. C. The multiple listing service was created so that member brokers could have a common place to share property listings. The other statements are FALSE.

11. B. If more people want to move into an area where there are fewer housing options, the prices of existing homes would likely rise initially.

12. B. Generally speaking, when a large number of people move into an area, available housing will be at a premium, which creates a seller’s market.

13. A. If the economic base is expanding, the real estate supply will also expand.

14. B. Low inflation generally results in lower wages and lower prices for goods, leading to lower construction costs.
15. B. When there is limited new construction, there are fewer houses available for sale, which is more likely to contribute to a seller's market.

16. C. When people move out of an area, there is an increase in the number of homes available for sale, resulting in a buyer's market.

17. B. Broad factors that impact the real estate market include physical, economic, governmental, and social: P-E-G-S.

18. D. Non-homogeneity is a characteristic of real property indicating that each piece of land, each building, and each house is a unique piece of real estate.

19. C. Inflation is an increase in the cost of goods or services. It can also be caused when too many people with money want to buy the same thing.

20. A. Physical characteristics of land include its immobility (cannot be moved), scarcity (cannot make more), and its uniqueness (each parcel is different). These characteristics also relate back to the land's location.

Chapter 2: Real Property Fundamentals

1. A. The Japanese garden, the uncut roses, and the greenhouse are all examples of attachments. The basketball hoop is not an attachment because it can be moved.

2. A. When real property is sold, appurtenant rights are usually transferred along with it. They can, however, be sold separately and may be limited by past transactions, as you saw in the example of Jack and his subsurface rights. Remember: Appurtenant rights “run with the land.”

3. B. Real estate is defined as the actual physical land (also known as unimproved land or raw land) and everything, both natural and man-made, that is permanently attached to it.

4. A. Appropriative rights are permits granted by the government, allowing an individual to use water from land he or she does not own. Reliction describes a body of water gradually receding and exposing land that was previously underwater. Littoral and riparian refer to the rights of landowners to use either flowing or lake water on their own property for their own use.

5. A. This is an example of accretion, which is a gradual addition to dry land by the forces of nature.

6. C. J's best argument is that the curtains were custom-made.

7. B. A leasehold improvement is installed by the landlord for the use of the tenant. Since the table and bench are attached to the house, they would most likely be considered the real property of the landlord.

8. A. A bill of sale is used to transfer ownership of personal property.

9. B. The curio cabinet might look nice in the room, but it is not a fixture. The dishwasher is still part of the real property even though it is not in the house. Keys are considered to be fixtures; you cannot use a property without one. The fence is attached to the land; it is a fixture.

10. C. The value of the item is not considered. Most often, the item is valuable. Intention and manner of annexation are the most heavily weighted factors.

11. A. L, the original tenant, installed the kiln for business purposes. It's a trade fixture, and it's L's personal property. L would have to remove it when the lease is up, or L could sell the kiln to A if they can agree to terms.

12. C. An improvement is any man-made attachment to the land. Although someone may have planted the pine trees, they are not, in fact, improvements but natural attachments.

13. B. At this point, those building materials are personal property. Once construction gets underway, they will become part of the real property.

14. D. The keys are attached conceptually, as opposed to physically, because of a close association with real property, which is known as constructive annexation.

15. A. An appurtenance is a right that goes along with ownership of real property. The other choices are synonymous terms to describe moveable property that is not attached to the land.

16. A. Fructus industriales, also called emblements, are crops, forests, or other plants intended to benefit the farmers of such plants.
17. **C.** Real property is defined as the actual physical land (also known as unimproved land or raw land), everything (both natural and man-made) that is permanently attached to it, as well as the bundle of rights.

18. **B.** Avulsion is the erosion of land through natural causes, such as flooding or earthquakes, which may remove soil or cause the collapse of riverbanks. U is gaining land through the process of reliction.

19. **B.** The right of disposition gives a property owner the ability to transfer all or some of the property.

20. **C.** The doctrine of emblements allows a tenant farmer to re-enter the land to harvest crops that were planted by the tenant farmer even after the land has been sold to a new owner.

### Chapter 3: Possessory Interests in Real Property

1. **B.** The two types of possessory interests are freehold and leasehold estates. Easements and liens are nonpossessory interests.

2. **D.** Even when the current owner holds the property as fee simple absolute, he or she can put limitations on the property that the new owner must follow.

3. **B.** Since V put a condition on the property, V limited what could be done with the property. This type of freehold estate is also called fee simple defeasible or qualified fee.

4. **D.** The right of re-entry, which is an element of a fee simple subject to a condition subsequent estate, means that the original grantor has to prove in court that the condition occurred; it is not automatic. The possibility of reverter, which is an element of the determinable fee estate, is automatic.

5. **D.** Z's life estate is a present estate. Z can live on the property, sell the life estate, or give the life estate away, but Z cannot will the life estate since the estate will terminate at Z's death.

6. **B.** Ownership and possession of the property will revert to G when life tenant K dies. G is the reversioner.

7. **B.** A life estate pur autre vie is inheritable. Therefore, if life tenant N dies before measuring life P, dies, the life estate goes to N's heirs.

8. **B.** The property goes to E when the life estate ends; E has a reversionary interest and is not the remainderman. The life estate continues as long as the life tenant, A, lives and cannot be terminated except by A's death or A's choice. A is the measuring life for the estate.

9. **B.** The estate will belong to D when the measuring life/life tenant C is dead. D is the remainderman, and he has a future interest in the estate.

10. **D.** Of these, only a conventional life estate is not inheritable since the estate ends at the death of the life tenant.

11. **C.** One who leases his property is called the lessor, or the landlord. A lessee or tenant is the person who rents the property.

12. **A.** A leasehold estate is considered to be personal property.

13. **C.** Lessors (owners) have a reversionary interest in the property, which means the property reverts to them at the end of the lease term.

14. **C.** During the term of the lease, tenant D has a leasehold estate, and owner N has a leased fee estate. When the lease is up and N moves back into the house, N has a freehold estate since she is now possessing her own property.

15. **C.** A lease that automatically renews like this is a periodic tenancy, also called an estate from year to year, even if it is a month-to-month lease.

16. **C.** A tenancy at will is not an inheritable estate, and it does not survive the death of the property owner (or a lessee). The leaseholds of these four tenants are terminated when W dies.

17. **B.** Tenancy at sufferance, also known as an estate at sufferance, describes possession of property by a tenant who came into possession of the property under a valid lease but stays on after the lease expires without the landlord's permission.

18. **D.** A tenancy for years has a specific time frame, such as three months, along with a set payment per month. Even though it is not for a full year, this still describes a tenancy for years, which requires no notice to end.
19. C. Since there is no specified time frame for the end of the lease, nor is there money exchanged, this is a tenancy at will. If the friend agrees to pay you some money once a month, then you would have a periodic tenancy.

20. A. In most cases, if a landlord accepts rent from a holdover tenant after the lease has expired, the landlord has essentially agreed to the terms, and a month-to-month or periodic tenancy is automatically created.

**Chapter 4: Nonpossessory Interests in Real Property**

1. D. With an easement in gross, the property that is burdened by the easement is called the servient tenement. It is serving the needs of the gas company by letting them dig up the lawn.

2. C. L has been using that land for a very long time and might meet the state statutory requirements to request an easement by prescription from the court to continue to cross T's property.

3. C. A license is temporary and revocable and gives a person permission to enter another's land for a particular purpose. A personal easement appurtenant could accomplish the same goal.

4. D. Since the two properties have been combined under one owner, the easement is terminated by a merger.

5. C. This situation most likely describes an easement, since it appears to have been conveyed with the property; licenses do not run with the land.

6. C. The property that benefits from the easement is known as the dominant tenement.

7. C. Both allow someone else to enter or cross another's property. A license, however, can be revoked at any time and is much less restrictive than an easement, which creates an encumbrance and runs with the land.

8. B. An easement in gross burdens one parcel of land for the benefit of an individual or a corporation.

9. B. Since this easement benefits a single person and has only a servient tenement, it is an example of a personal easement in gross.

10. D. A negative easement prevents the servient tenant from using his or her own land in a certain way.

11. B. An easement by prescription is created by open and notorious, hostile and adverse use of another person's land for a specific period of time determined by state law. Prescriptive use does not have to be exclusive.

12. C. A lien does NOT give the lienholder a right to possess the property. The other statements are true.

13. C. A mechanic's lien is involuntary and specific. Mortgage liens are voluntary, and judgment liens are general. An easement is not a lien, though it is an encumbrance.

14. B. A judgment lien could be voluntary if the property owner negotiated a resolution to a case, rather than wait for a verdict from a judge or jury.

15. D. Property tax liens, also called ad valorem tax liens, are always superior to any other lien.

16. A. Judgment liens are general; they can attach to any property a debtor owns.

17. D. A mechanic's lien is filed by a contractor, laborer, or materials supplier whose work or materials enhanced the value of real property.

18. C. Special assessments may be imposed by jurisdictions with taxing authority on specific neighborhoods or areas in order to pay for specific improvements that benefit that neighborhood. A specific project such as new siding for one specific property owner would not warrant a special assessment.

19. D. Property tax liens are always paid first. Then liens are generally paid in the order in which they were filed.

20. A. There are a few liens that are involuntary general liens: some judgment liens and some tax liens, such as a lien for unpaid income tax.

**Chapter 5: Forms of Ownership**

1. C. Tenancy in common allows one co-owner to transfer his or her share of the property to others by deed or devise.

2. A. The only unity required for tenancy in common is possession.
3. C. With tenancy in common, each co-owner has an equal right to possession of the entire property, even if their interests are unequal.

4. D. They have unity of person since they are married. They also have unity of possession, since both live in the house. The deed is in Q's name, so there is no unity of interest, time, or title. Q could sign a new deed indicating both P and Q as tenants by the entirety, joint tenants, or tenants in common.

5. B. Tenancy in common is the only form of co-ownership that does not require the unity of interest, meaning an unequal fractional interest is possible.

6. D. Ownership in severalty is ownership held by one person.

7. B. Joint tenancy generally includes the right of survivorship. When one joint tenant dies, that interest is automatically transferred to the remaining joint tenant(s). In this case, H is the only remaining owner and so owns the property in severalty.

8. B. A and B are joint tenants, which includes the right of survivorship. B's share goes to A.

9. A. Tenants in common do not have the right of survivorship. If one dies, her interest in the property goes to her heirs, not the other co-owners, unless, of course, S had named them in her will as heirs.

10. B. Joint tenancy, a freehold estate, allows an owner to sell his interest. If there were three joint tenants, for example, the new owner holds the sold interest as a tenant in common with the two remaining joint tenants.

11. D. Tenancy in common would allow one co-owner to own a greater interest than another co-owner. Joint tenancy and tenancy by the entirety require the unity of interest. Severalty is sole ownership, not co-ownership.

12. B. A corporation, which is a legal person, owns the property in severalty.

13. C. The key word is “beneficiaries,” who are paid profit from a REIT, or real estate investment trust.

14. A. B, as trustee, holds the title to the property, although the terms outlined in the trust limit B’s power.

15. C. Syndicates generally are ongoing projects involving multiple properties that require large amounts of capital.

16. A. While the beneficiary of a land trust may generally remain anonymous, his name must become public if he intends to subdivide and develop the land that is the subject of the land trust.

17. D. A limited common area describes an area everyone in the complex owns but only one person uses.

18. C. A cooperative typically provides a proprietary lease to its shareholders. T is a shareholder of the corporation that owns Royal Tower.

19. A. The government levies condo owners individually for property taxes. The other statements are false. W can give the unit away in her will. There is no restriction on how W takes title to the unit. W will be a tenant in common for the common areas.

20. D. N owns the property with several other people who share the property, and each has a designated time period when they can occupy the property.

Chapter 6: Title Transfer and the Public Records

1. D. Descent, devise, and escheat are all related to someone's estate after death.

2. D. Signing a deed is the most common example of voluntary alienation. The other choices are examples of involuntary alienation.

3. C. J voluntarily transferred private property for public use, so this is alienation by dedication.

4. D. With a will is testate; without a will is intestate.

5. A. This is acquisition through adverse possession.

6. D. When someone dies intestate and has no heirs, the property reverts to the state through the process of escheat. Note that in some states, property escheats to the county in which the property is located, not the state.

7. C. Quitclaim deeds convey any interest in real estate a grantor may have at the time the deed is executed. It could be used to clear a cloud on the title such as a misspelled name on a deed.
8. **B.** Title can transfer once a deed meets validation requirements and there is delivery and acceptance. Recording does not transfer title.

9. **D.** A valid deed must have the names of the parties, consideration, granting clause, legal description, and execution. Though common, a recital is not required.

10. **C.** A sheriff's deed, which is a type of judicial deed, or a bargain and sale deed, which has no warranty at all, are typically used. It may also be referred to as master commissioner's deed. Of these options, a limited warranty deed would be the least likely to be used in a foreclosure sale.

11. **B.** The deed that grants property to the buyer is required to be signed only by the seller, also known as the grantor.

12. **C.** Seizin is the ownership of a freehold estate. The covenant of seizin is a guarantee that the grantor has the right to convey that estate.

13. **B.** A general warranty deed gives the grantee the greatest possible protection.

14. **D.** Documents are recorded to give the world constructive notice of legal transactions involving property. The public can gain actual notice by going to the county courthouse and seeing the records.

15. **A.** The law says everyone has constructive notice, or presumed knowledge, of recorded documents. Once you actually have seen the documents that pertain to property ownership, you have actual notice.

16. **C.** Encroachments are generally discovered through a survey of the property, while the other information would likely be available in the public records.

17. **C.** All of these are defects that could be a cloud on the title, but only an undisclosed owner is a fault that would appear in the chain of title, which is a clear and unbroken chronological record of the ownership of a specific piece of property.

18. **C.** A string of successive conveyances from one owner to the next owner arranged consecutively from the first recorded owner of the property to the current owner is called a chain of title.

19. **D.** A buyer expects to receive marketable title and the seller is expected to convey defects.

20. **D.** Title insurance is the best evidence of marketable title.

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**Chapter 7: Describing Real Property**

1. **B.** Of these documents, a listing agreement would least likely require a legal description of the property.

2. **C.** 2S would be two tiers south of a baseline; 3W would be three ranges west of a principal meridian.

3. **A.** A township tier is the six-mile strip of land between township lines, which are parallel to baselines. Therefore, a township tier runs east and west. Ranges run north and south between range lines, parallel to a meridian at six-mile intervals.

4. **B.** The first parcel would be $640 \div 4 \div 4 = 40$ acres. The second parcel would also be $640 \div 4 \div 4 = 40$. Add the two together, and the total acreage would be 80.

5. **A.** Each section is 640 acres. Working backward: $640 \div 4 \div 4 \div 4 = 10$. There are 10 acres in the NE 1/4 of the NE 1/4 of the NE 1/4 of Section 16.

6. **C.** The first parcel would be $640 \div 4 = 160$ acres. The second parcel would be $640 \div 4 \div 2 = 80$. Add the two together, and the total acreage would be 240.

7. **C.** Each township is comprised of 36 sections that are one square mile, or 640 acres, each.

8. **B.** Each range is six miles wide, north to south.

9. **B.** Correction lines run every fourth township line—or 24 miles—as a way to address the curvature of the earth, setting the range back to 6 miles wide.

10. **C.** Section 25 is one tier south of Section 20 and four ranges east.

11. **C.** The metes and bounds system uses distance (metes) and direction (bounds) to describe the boundaries of a parcel of land, using fixed monuments, such as a feature of the land or a surveyor pin.

12. **C.** Metes and bounds descriptions always start and end at the point of origin, or point of beginning.
13. C. A lot and block number that identifies property is found on a plat (map), recorded and indexed.
14. C. First, divide the base of the triangle by 2 (1,254 feet ÷ 2 = 627 feet) then multiply by depth (627 feet x 820 feet = 514,140 SF). Finally, you can divide that by the number of square feet in an acre: 514,140 SF ÷ 43,560 SF per acre = 11.8 acres.
15. D. Since the parcel is square, all the sides are the same length. First, multiply the width by the length to get the square footage: 1,890 feet x 1,890 feet = 3,572,100 square feet. Then divide that by 43,560: 3,572,100 SF ÷ 43,560 SF per acre = 82 acres. This will be an 82-acre park.
16. A. Lot B is 43,005 square feet, divided by the length of 235 feet, which gives you a lot width of 183 feet.
17. C. Property C has 8,100 square feet (90' x 90'), and its price is $49,500 (90' x $550/front foot). It would give her the most frontage for under $50,000.
18. A. First, divide D's cost by the cost per acre: $56,250 ÷ $12,500 = 4.5 acres. D bought 4.5 acres. To convert to square feet, multiply by 43,560: 4.5 acres x 43,560 SF per acre = 196,020 square feet.
19. B. A 3.45-acre lot has 150,282 square feet (3.45 acres x 43,560 SF). At 50 cents per square foot, the selling price is $75,141 (150,282 SF x $0.50).
20. A. To find volume, you need to multiply length x width x height. That gives you cubic feet of 475,200 (110 feet x 180 feet x 24 feet). To find cubic yards, you need to divide that by 27 (475,200 cubic feet ÷ 27 cubic feet per cubic yard = 17,600 cubic yards).

Chapter 8: Agency Fundamentals

1. B. The principal in any fiduciary relationship is the client. The agent is also known as a fiduciary.
2. D. J is a universal agent. His sister authorized him to do anything and everything that can be lawfully delegated to a representative.
3. A. A real estate licensee is a general agent of his or her broker. The broker, the principal in that relationship, gives general authority to his agents to conduct real estate business on his behalf.
4. C. There is a written contract between T and XYZ, making this an express agency, regardless of who is paying the compensation.
5. A. E’s current address is likely to be a matter of public record. All of the other choices could be considered confidential information since they could—at the very least—hint at E’s financial situation and motivation.
6. B. A licensee has a duty to disclose the property’s true value. The licensee’s behavior is regarded as self-dealing. The licensee also breached the duties of loyalty and reasonable care.
7. D. In most states, real estate licensees can complete blanks on standardized forms for their clients, but they cannot draft original contracts. This would be considered the unauthorized practice of law.
8. A. Even though Y is not P’s agent, Y still owes P honesty as a customer.
9. B. Of course, all of these are duties that an agent owes a client, but advocating for a customer over the interests of a client is most likely a breach of the duty of loyalty. Agents must be loyal to clients, not customers.
10. A. The details of T’s negotiations with the buyer are confidential information. R’s fiduciary obligation does not end at the termination of the agency relationship unless former client T gives R written permission to divulge that information.
11. D. When a party to a contract—in this case, a listing agreement—dies, the agency relationship terminates as an operation of law.
12. C. When the seller and the broker execute a listing agreement, they create an agency relationship.
13. A. Of these options, the home show is least likely to be considered substantive contact where confidential information is likely to be shared.
14. B. In states that recognize designated agency, the broker delegates the authority to act as the legal agent of the client to one or more affiliated licensees to the exclusion of any other affiliated licensee.
15. C. Ministerial acts are those things that a licensee does for a customer that do not rise to the level of agency representation.
16. C. In most states, a licensee may act as a dual agent only with the written consent of both parties to the transaction.

17. A. An agent's duty of obedience only applies to lawful instructions. D must disclose material defects, whether patent or latent. D might decide, however, that he is not willing to work with this client, though he's not obligated to walk away.

18. D. Megan’s Law, adopted by the federal government in 1996, requires states to develop a procedure to notify community residents of sexual offenders living in their area.

19. A. Information about the condition of the property is usually considered to be material, and the presence of a nearby factory could have some bearing on that property's condition. An owner's opinion about the house being haunted would most likely not be considered a material fact.

20. B. The buyer's financial situation could jeopardize the entire transaction and is a material fact. If the seller turned down another offer with the expectation of P getting a mortgage and the deal falls through, K will have breached his duty of disclosure, which he owes to clients and customers.

Chapter 9: Real Estate Brokerage

1. C. A listing agreement is a contract that creates an agency relationship between a seller and a broker.

2. C. A listing agreement is a contract between the client and the broker at Ace. As such, the broker owns those listings and you cannot take them with you, even if you are the agent who worked to get the signed listing agreements.

3. C. With a net listing, the seller sets a net amount he is willing to accept for the property, and the broker is entitled to keep any amount in excess of that as commission.

4. B. Only the exclusive right to sell listing agreement entitles a broker to a commission no matter who finds the buyer.

5. D. When a seller offers a commission to any broker who finds a buyer, this could be a form of an open listing. The seller does not recognize any exclusive agency.

6. A. Under an exclusive agency agreement, the seller can still sell the property on his own and not owe a commission. In an exclusive agency listing, unlike an open listing, only the listing brokerage can put a sign in the yard and advertise it.

7. C. Most states require listing agreements to contain a definite termination date. The other items are negotiable, and a licensee must inform the consumer of that fact.

8. C. A nonexclusive buyer agency agreement or open buyer agency agreement is one in which a broker earns a commission only if she is the agent who introduces the buyer to the property he purchases. This agreement offers the least protection for a broker to receive a commission.

9. B. The management agreement between a property manager and a property owner creates an agency relationship.

10. C. The listing agent commission is 7%, but the seller is not obligated to pay the buyer's broker anything.

11. C. A broker is generally entitled to commission only after fulfilling the duty of finding a ready, willing, and able buyer on the seller's terms. The agency agreement should, of course, spell out the specific conditions of the compensation.

12. C. When calculating commission, multiply the sales price (Total) by the commission percentage (Rate): $186,000 x 6.5% (0.065) = $12,090 commission.

13. D. ABC was the cooperating brokerage, so they received a 3% commission, or $5,340. To find the sales price of the property, divide the commission by the rate: $5,340 (Part) / .03 (Rate) = $178,000 (Total). The property sold for $178,000.

14. D. A licensee may only receive compensation directly from her broker. In a cooperative sale, the respective brokers will pay their respective licensees.

15. D. What a broker charges for a commission is purely negotiable between the broker and a client.
16. B. It breaks down this way: 5% of $200,000 = $10,000; 4% of $300,000 = $12,000; and 6% of $100,000 = $6,000. Add them together to get $28,000.

17. B. First, find out how much Lakeside earned with their 3% commission: $432,000 x 0.03 = $12,960. Then find T's 55% share of that: $12,960 x 0.55 = $7,128.

18. C. This is a two-part question. First, determine the total commission made on the sale. If M receives $11,268 as half of the commission, then the total commission is $22,536. Now, use the commission formula. Commission Rate (%) = Commission (Part) ÷ Sales Price (Total): $22,536 ÷ $375,600 = 0.06. The commission rate charged was 6%.

19. B. First, find the total commission: $462,700 x 0.075 = $34,702.50. Next, find Uptown's share: $34,702.50 x 0.045 = $15,616.13. Then find J's share of that: $15,616.13 x 0.60 = $9,369.68. J will receive $9,369.68 in commission at closing.

20. B. We don't know the total commission paid, but we know that buyer's broker Sue earned $5,660, which was 4% of the sales price. To find the sales price of the home, then, divide the commission by the commission rate: $5,660 ÷ 0.04 = $141,500.

**Chapter 10: Federal Fair Housing**

1. D. There are no exemptions under the Civil Rights Act of 1866. Racial discrimination is never acceptable.


3. D. Even though the building has four-units, which allows some leeeway, when a real estate licensee is involved, there are no exemptions. Also, her race was a factor in the refusal, and that is a clear violation. If his only reason for rejecting her application was her credit issues, there would be no problem.

4. C. The federal Fair Housing Act prohibits discrimination in the sale or lease of residential property based on these protected classes: race, color, national origin, religion, sex, disability, and familial status.

5. B. Choices A, C, and D could be alleged to be discriminatory in that they might be used to single out individuals on the basis of familial status or religion.

6. C. Age is not a protected class under the federal Fair Housing Act. All of these other choices are examples of familial status protection. Remember, however, that age could be a protected class in the state or city in which you practice.

7. D. A woman who is pregnant is considered part of the familial status protected class. Unless the exemption criteria are met, it is unlawful to discriminate based on the fact that V will soon have a child living with her.

8. A. The Fair Housing Act requires reasonable accommodation that would allow a guide, hearing, or support dog for individuals with disabilities.

9. C. Steering relates to buyers or renters and is defined as channeling prospective buyers or renters to or away from specific neighborhoods.

10. C. It is not against the law to refuse to enter into a contract with someone who has not yet attained the legal age of majority. If the refusal to contract was based only on one's membership in a protected class, however, that would be a violation.

11. A. Blockbusting is defined as inducing or attempting to induce, for profit, any person to sell or rent property based on representations made regarding entry into the neighborhood of persons in a protected class. Blockbusting is also referred to as panic selling or panic peddling.

12. C. The federal Fair Housing Act requires landlords and owners to make provisions for accessibility, but it does not require the landlord to bear the expense of the renovations. The landlord is also allowed to require the property to be returned to its original condition upon termination of occupancy.

13. C. Anyone can file a complaint of discrimination with HUD's Office of Fair Housing and Equal Opportunity (FHEO) within one year of the incident.

14. C. A claimant can file a civil lawsuit in Federal District Court based on the federal Fair Housing Act within two years of the alleged discriminatory incident.
15. A. This would be a permitted advertisement because it does not discriminate against membership in a protected class. It's important to note, however, that L is not exempt from following fair housing laws related to advertising; it's just that his restriction against college students does not violate fair housing laws.

16. A. In this example, the word “exclusive” is a restricted word in real estate advertising.

17. C. Q should work with a national, state, or local fair housing agency when pursuing a fair housing complaint. She could also file a civil lawsuit.

18. D. Once the owner chose to use a real estate licensee, the exemption to familial status was no longer available. S could file a complaint against the owner, the agent, and the broker of the agent's brokerage.

19. C. The refusal to make loans on property in certain neighborhoods for discriminatory reasons is called redlining, which the Federal Fair Housing Act prohibits.

20. D. A licensee must follow the laws governing the federal Fair Housing Act, even if the seller is in violation. If the listing is active, the licensee should consult with her broker so that the broker may determine the method in which to proceed or terminate the listing.

Chapter 11: Contract Fundamentals

1. D. The contract could be voidable by S because S lacks legal capacity to contract due to age. However, S could choose to affirm the contract. If all legal requirements are in place, M is bound to fulfill his contractual obligations and complete the sale.

2. B. An executory contract is one in which the parties have agreed to the terms but some conditions remain to be fulfilled. Once all conditions are met and all that remains is the closing, the contract is said to be complete, or executed.

3. A. Consideration, not consequence, is the other essential element for a valid and enforceable contract.

4. B. The acceptance must be clearly communicated back to the person who made the offer, the offeror.

5. C. The contract is a unilateral express contract since one party makes a binding promise in words to the other party to act, even though there is no obligation for the second party to act.

6. C. The contract is express because it is written, unilateral because only H has made a binding promise, and executory because both parties have yet to perform the obligations of the agreement.

7. C. The contract is void and unenforceable because S did not have capacity at the time she signed.

8. D. If mom does not offer something in return for M's promise to clean the house, this is not a contract.

9. D. A counteroffer is both the rejection of the original offer and the making of a new offer with new terms. Once the offer has been rejected, it may not be accepted later.

10. D. Rejection automatically terminates an offer. A rejected offer does not have to be formally withdrawn or revoked. An offer may also be terminated by lapse of time, communication, or notice of revocation before acceptance, qualified acceptance (counteroffer), or death or insanity of either the offeror or the offeree before acceptance.

11. B. Seller E, originally the offeree, is now the counterofferor. J, the original offeror, is now the counterofferee.

12. A. While there is likely no state statute about the order to present offers, the seller has the right to know all the facts and look at all the offers before reaching a decision.

13. D. A state's Statute of Frauds requires real estate contracts to be in writing in order for the courts to enforce the contract.

14. A. A contingency clause is a condition placed on a contract.

15. A. H will likely have to pay L $10,000 in compensatory damages for the money she had already spent.
16. C. The buyer may be able to terminate the contract due to the impossibility of the seller to perform or accept the property as is. The buyer has equitable title and may claim any insurance proceeds for real property damage.

17. D. This is known as specific performance, which occurs most often when the non-breaching party to a contract cannot be compensated for the harm that resulted from the other’s breach.

18. A. H repudiated this contract; thus, O may immediately file a lawsuit for breach of contract without making a tender offer.

19. B. Novation substitutes one contract for another or one party to the contract for another.

20. D. Liquidated damages reflect the amount of money specified in a contract to be returned in the event the contract is terminated.

Chapter 12: Real Estate Contracts

1. B. A purchase agreement, also called an agreement of sale or a purchase contract, is the contract between the buyer and the seller.

2. B. A purchase agreement is a bilateral contract. Because both parties have not yet completed their contractual obligations—the buyer paying the seller and the seller turning over possession—the contract is executory. Also, we can assume if it’s passed attorney review, it’s a valid contract.

3. B. The buyer will not receive legal, or actual, title to the property until the transaction closes and the deed is handed over. In the meantime, he does have equitable title to the property because of the signed purchase agreement.

4. D. An option to purchase requires the one who gives an option (the optionor, seller L) to complete the sale if the one who receives the option (the optionee, buyer D) wants to do so. D is under no obligation to complete the purchase; however, he is out the $2,000 whether he buys or not.

5. C. This is an option agreement. P pays her friend consideration of $1,000 in return for an option to purchase the property any time within the six-month period.

6. B. The optionee (buyer) enforces the option to purchase from the seller (optionor).

7. D. This is a unilateral contract. Only T is obligated to perform. Because the contract is open, it is considered executory.

8. D. Earnest money is evidence of the buyer’s good faith when making an offer, but it is not required in any way. If the deal falls through, it generally serves as liquidated damages to the seller.

9. A. A contingency clause is a condition placed on a contract.

10. D. While the purchase agreement is the contract between the buyer and the seller, most standardized contracts are created by local associations of REALTORS® and bar associations.

11. C. One who leases her property is called the lessor or the landlord. A lessee, or tenant, is the person who rents the property.

12. B. The landlord and the tenant are the parties to a lease. The landlord and the property manager are the parties to a property management contract.

13. C. The tenant must have the legal capacity to enter into a contract, which means he must be at least 18. A lease does not have to be in writing to be valid (though it might need to be in writing to be enforceable), and a security deposit is not required. A standardized contract is helpful, but not required.

14. B. Most residential leases are straightforward gross leases.

15. A. A graduated lease will spell out step-by-step rent increases, which are often paid in installments.

16. C. Although consideration is required for a valid lease, a security deposit is not consideration. In a leasing situation, consideration is the rent. The other choices would be required for the lease to be valid AND enforceable.

17. D. With a sublease, the tenant is transferring partial rights in the property, but remains solely liable.

18. B. This a gross lease, in which the tenant pays a fixed rent, while the owner or landlord pays all ownership expenses, such as property taxes, repairs, insurance, and sometimes utilities.
19. D. A percentage lease allows the property owner to take benefit from his tenants’ success.

20. C. The substitution of a new contract, with the withdrawing party relieved of liability, is novation.

Chapter 13: Financing Principles

1. D. Fannie Mae is the primary player in the secondary market. If a primary lender wants to sell a loan to Fannie Mae, it must follow the secondary market guidelines. This is known as a conforming loan.

2. B. The primary market consists of lenders making mortgage loans directly to borrowers. Primary lenders include commercial banks, savings and loans (S&Ls), savings and mutual savings banks, and mortgage bankers.

3. A. Mortgage brokers do not originate, service, fund, or underwrite loans to lenders. Instead, they earn a fee to act as an intermediary to bring together borrowers and the lenders who originate the actual loans.

4. B. The Federal Reserve is responsible for managing the supply of money. While the actions of the Fed may influence the interest rates that lenders charge, the Fed does not set consumer interest rates.

5. C. The secondary market exists to standardize loan qualifying criteria and buy loans from the primary market as a stabilizing influence. The secondary markets do not loan money nor do they accept deposits from consumers.

6. A. Servicing activities include collecting and processing payments including taxes and insurance, accounting, bookkeeping, and other follow-up services.

7. D. Deeds of trust, land contracts, and mortgages are all types of security instruments. A promissory note is a financing instrument.

8. B. The alienation clause, also called a due on sale clause, gives the lender certain stated rights when there is a transfer of ownership in the property. One option would be to call the loan due in full.

9. C. A borrower hypothecates his or her property as a condition of a loan, meaning he pledges his real and/or personal property as security or collateral for the loan, while still maintaining possession of it.

10. C. A prepayment clause imposes a fee on a borrower who pays off his mortgage before the term ends. If a borrower wants to pay more toward principal, which in effect would retire the loan earlier, he should check and see whether his mortgage and/or promissory note includes such a clause and if so, its timeframe.

11. D. A loan that is fully amortized means the total payments over the life of the loan will pay off the entire balance of principal and interest due at the end of the term.

12. C. A straight loan is interest only. At the end of the loan term, Victoria would have a balloon payment for the principal of $60,000.

13. A. The annual interest L pays is $7,300 ($146,000 x 0.05). Divide that by 12 to find $608.33 as the amount applied to interest with that first payment ($7,300 ÷ 12 months = $608.33). Subtract the monthly interest from the total amount of the monthly payment to find the principal reduction ($963.54 - $608.33 = $355.21).

14. C. The annual interest is $7,837.50 ($165,000 x 0.0475). Divide by 12 to find the amount applied to interest with the first payment: $7,837.50 ÷ 12 months = $653.13. Subtract that from the loan balance to find the amount applied to principal: $860.72 - $653.13 = $207.59. Subtract the principal reduction from the original balance to find that the new balance: $165,000 - $207.59 = $164,792.41. Walk through the steps again to find the balance after the second payment: $164,792.41 x 0.0475 = $7,827.64. $7,827.64 ÷ 12 months = $652.30. $860.72 - $652.30 = $208.42. $164,792.41 - $208.42 = $164,583.99. The principal balance after making the second payment is $164,583.99.

15. C. B will pay $140,272 in interest for that 30-year loan. $695.20 P&I x 12 months x 30 years = $250,272 total payment – $110,000 principal = $140,272 interest.

16. C. With an adjustable rate mortgage, the index is added to the negotiated margin to determine the interest rate for the loan.
17. D. A reverse mortgage provides monthly income, a lump sum of cash, or a line of credit to borrowers aged 62 or older, based on the equity in their homes.

18. A. A blanket mortgage covers more than one parcel of land.

19. C. This could be an example of predatory lending.

20. A. A straw buyer is someone who allows his name and credit history to be used to apply for a loan on property he will not occupy. A is using his own name to buy a house he wants to live in, but he's falsifying documents. It's an example of mortgage fraud, but he is not a straw buyer.

Chapter 14: Financing Practice

1. B. Prequalification is a way that a lender can get a rough idea of how much of a mortgage a buyer might be able to afford. It is not binding on the lender in any way.

2. C. The lender (mortgagee) provides this service to a borrower (mortgagor) by adding one-twelfth of the insurance premiums and taxes to the monthly mortgage payment amount.

3. C. A point is 1% of the loan amount. Since J made a $30,000 down payment, the loan amount is $120,000. One point of the loan is $1,200, so three points is $3,600. This would bring the note rate down by 3/8 of a point.

4. B. Borrowers must receive the Loan Estimate, which includes the disclosure of the annual percentage rate, within three business days after the submission of a completed loan application.

5. D. The provisions of RESPA apply to federally-related mortgage transactions for any one-to four-family residential property. A cash transaction would not be subject to the disclosure requirements of RESPA.

6. A. The Consumer Financial Protection Bureau is an agency funded by the Federal Reserve with rulemaking and enforcement authority over TILA and RESPA, among other consumer financial laws.

7. C. The Equal Credit Opportunity Act requires creditors to notify applicants of their lending decision—whether credit was extended or rejected—within 30 days of the filing of a complete application.

8. D. The Truth in Lending Act, which requires lenders to disclose the actual/total costs involved in acquiring credit, is implemented by Regulation Z.

9. C. There is a 7 business-day waiting period after all required disclosures are delivered to the borrower before the loan can close.

10. A. Savings, the previous sale of a home, and gifts are all acceptable sources of down payment, but the buyer is usually not allowed to use borrowed funds.

11. A. The cable TV channel is a debt that could more likely be canceled, while the others would have to be considered as recurring debts that impact the applicant’s qualifying ratios.

12. D. All people must be considered for credit equally on the basis of income adequacy, sufficient net worth, job stability, and satisfactory credit rating. Regardless of whether the borrower meets all other criteria, it would be a violation of the Equal Credit Opportunity Act (ECOA) to consider the source of that borrower’s stable monthly income.

13. B. The housing expense (front-end) ratio for a conventional loan is 28%. The debt-to-income (back-end) ratio is 36%. Looking at the debt-to-income ratio: $3,000 (income) x 0.36 = $1,080. From there, subtract his monthly debts: $1,080 - ($350 + $50 + $50) = $630. The lender will consider the lower number.

14. D. The lender bases the loan-to-value on the lesser of the sales price or the appraisal value. If the buyer is paying $230,000 on a house appraised at $225,000, the lender will loan $180,000 ($225,000 x 0.80). That means the buyer will have to make a down payment of $50,000 ($230,000 sales price - $180,000 loan) to close the deal.

15. C. The Homeowners Protection Act of 1998 (HPA) requires lenders to automatically cancel PMI when a home has been paid down to 78% of its original value, assuming the borrower is not delinquent. A borrower can also request the removal of PMI once he has paid the loan down to 80% LTV.
16. **B.** The first mortgage amount is $160,000. The second mortgage amount is the sale price minus the first mortgage and the down payment amount: $200,000 – $190,000 ($160,000 first mortgage + $30,000 down payment) = $10,000. The sum of all liens on the property is $170,000 ($160,000 + $10,000 = $170,000). Divide the total amount borrowed by the sales price to find the combined loan-to-value: $170,000 / $200,000 = 85% CLTV.

17. **A.** Most FHA-insured loans require a down payment of at least 3.5% of the home’s purchase price or appraised value, whichever is less. If the purchase price is $105,000, the buyer would have to make a down payment of $3,675 ($105,000 x 0.035).

18. **C.** For VA-guaranteed loans, lenders require a certificate of reasonable value.

19. **D.** With a judicial foreclosure, the lender must first record and then serve a notice of foreclosure when the borrower defaults. After the reinstatement period expires, a foreclosure action may be filed in court. After the equitable redemption period expires, a sheriff’s sale is held.

20. **D.** A short sale occurs when the lender is willing to accept less than what is owed on the property as a purchase price to avoid the foreclosure process.

## Chapter 15: Valuation Fundamentals

1. **C.** An appraisal is only an estimate or opinion. It is not a guarantee of value or the ultimate price that a buyer actually pays.

2. **D.** After developing the approaches to value, the next step is reconciliation, where the appraiser analyzes the values derived from the different appraisal approaches to find a final value opinion.

3. **D.** The rules in the Uniform Standards of Professional Appraisal Practice (USPAP) are recognized throughout the United States as the accepted standards of ethics and appraisal practice.

4. **C.** Determining the highest and best use is something that should be considered in every appraisal approach; it is not a recognized appraisal approach in and of itself.

5. **B.** Highest and best use is the use that is the most physically possible, legally permissible, economically feasible, and maximally profitable or productive. A home in a residential neighborhood meets these criteria.

6. **C.** A property's price is the amount a ready, willing, and able buyer agrees to pay for a property and a seller agrees to accept under the terms of the transaction.

7. **B.** The four value characteristics are demand, utility, scarcity, and transferability (remember D-U-S-T). Immobility is a physical characteristic.

8. **D.** Liquidation value is the value a property could get if sold under the duress of a must-sell situation with less than typical market exposure.

9. **B.** Almost anything can define a neighborhood, except for race, ethnicity, and other characteristics of protected classes.

10. **C.** Plottage is an increase in value (over the cost of acquiring the parcels) by successful assemblage, usually due to a change in use. By creating a larger parcel with more utility and higher and better use than the individual sites, the owner has successfully achieved an increase in the inherent value of the land.

11. **A.** The principle of conformity says that a particular property achieves its maximum value when it's surrounded by properties that are similar in style and function. This goes for neighborhoods as well. Neighborhoods are more desirable when there's a general similarity in utility and value for all properties.

12. **D.** The principle of regression states that the value of the “best” home in a neighborhood is lower than what it might be in a neighborhood of comparable homes.

13. **C.** The principle of contribution says that a particular item or feature of a home is only worth what it actually contributes in value to that piece of property. The value of an item or improvement is only equal to what a prospective buyer is willing to pay for it, not what it actually cost the owner to install or construct it.

14. **D.** The principle of substitution says that an informed buyer would pay no more for the property than what the buyer would pay to obtain a similar one with the same benefits and utility.
15. B. The principle of contribution says that a particular item or feature of a property is only worth what it actually contributes in value to that piece of real estate.

16. C. An arm’s-length transaction is a typical transaction, for example, where the buyer and seller aren’t related, are not acting under duress, and do not involve unusual payment concessions.

17. D. CMAs are most often developed by a real estate licensee to assist the seller by providing a range of probable selling prices for the given subject home.

18. B. A CMA is primarily concerned with the observable differences between houses that would draw a buyer to one house over another.

19. D. First, add all of the expenses to find the desired net after commission: $2,000 + $150,000 + $58,000 = $210,100. Then determine the amount of the sales price left after commission: 100% - 7% = 93% or 0.93. Finally, divide the desired net by the commission: $210,000 / .93 = $225,807. He must sell his home for at least $225,807 to get the desired net and pay the contracted commission and other expenses.

20. C. First, add all of the expenses to find the desired net after commission: $96,000 + $12,000 + $10,000 + $3,100 = $121,100. Then determine the amount of the sales price left after commission: 100% - 7% = 93% or 0.93. Finally, divide the desired net by the commission: $121,100 / .93 = $130,216. James must sell his home for at least $130,216 to get the desired net and pay the contracted commission.

Chapter 16: Real Property Appraisal

1. C. The income approach is the most useful appraisal approach when determining the value of investment property.

2. C. When an appraiser is looking for comps, he will look only at homes that have sold recently.

3. B. When making adjustments, an appraiser subtracts the value of a superior feature from the comp’s value.

4. D. The first adjustment to be made would be any difference in the property rights conveyed, for example, if the subject will be transferred fee simple and the comp was transferred as a leasehold estate. This adjustment must be made first because it is usually adjusted as a percentage of the comparable’s sales price, rather than a set dollar amount.

5. A. When making adjustments, add the value of an inferior feature to the value of the comparable property, and subtract the value of a superior feature. Comp #3 sold for $200,000. Add $4,000 for the missing bathroom and $6,000 for the missing fireplace. Then subtract $12,000 for the pool. The adjusted value for the comp is $198,000.

6. C. To calculate remaining economic life, simply subtract the effective age (20 years) from the total expected life (70 years).

7. D. External obsolescence occurs when something outside the control of a property or its owner makes it less desirable. The factors causing the obsolescence may be economic, environmental, or due to location.

8. A. The cost approach must also account for the accrued depreciation as well as the value of land.

9. C. Only improvements are depreciated, never land.

10. A. Cost estimates for the reproduction of a building are typically done for historical buildings, where it is important for a new structure to have the exact same look and feel as the original.

11. C. Functional obsolescence occurs when a building is less desirable because of something inherent in the design of the structure.

12. C. First, find the replacement cost by multiplying the price per square foot by the number of square feet: $120 x 2,150 = $258,000. Next, determine the accrued depreciation using the age-life ratio: 20 ÷ 60 = 0.3333. The depreciation is $85,992 ($258,000 x .3333). Subtract the depreciation from the replacement cost to find value of the improvement: $258,000 - $85,992 = $172,008. Finally, add in the site value to find the final opinion of value: $172,008 + $57,000 = $229,008.

13. B. The gross rent multiplier method is generally used for residential rental property of one to four units. Only the duplex, sometimes called a two-flat or a double, meets these criteria.
14. **D.** To determine GRM for this example, you take the sales price ($200,000) and divide by the $1,800 monthly income ($900 x 2 units = $1,800):

$$\frac{200,000}{1,800} = 111.11 \text{ GRM.}$$

Remember, when figuring GRM, you do not consider expenses. Also, unless directed otherwise, assume a monthly GRM, not an annual.

15. **D.** $1,800 (monthly rent from the three units) x 121 (GRM) = $217,800. Vacancy loss is not considered when using the gross rent multiplier.

16. **A.** The net operating income should take into consideration property taxes, property management fees, and reserves for replacement. Depreciation is NOT counted, nor is debt service.

17. **C.** Take the NOI of $40,000 and divide it by the 10% cap rate to get $400,000. If the buyer is looking for a 10% return, he would likely be willing to pay $400,000 for that property.

18. **B.** Income (NOI) divided by Value (sales price) equals Rate: $14,400 ÷ $200,000 = 0.072, or 7.2% Rate (cap rate).

19. **C.** Start with potential gross income: ($2,000 x 10 x 12 = $240,000). From that, subtract 20% vacancy: $240,000 - 20% = $192,000. Add the miscellaneous income: $192,000 + $1,000 = $193,000. Finally, subtract expenses to find the net operating income: $193,000 - $108,000 = $85,000. Use IRV to find the value: $85,000 ÷ 0.095 = $894,737.

20. **D.** First, determine the accrued depreciation using the age-life ratio: 40 ÷ 100 = 0.40. If the cost is $460,000, the depreciation is $184,000 ($460,000 x 0.40). Subtract depreciation from cost to find value of the structure: $460,000 - $184,000 = $276,000. Finally, add in the site value to find the final opinion of value using the cost approach: $276,000 + $120,000 = $396,000.

**Chapter 17: Land Use and Environmental Issues**

1. **C.** This is known as police power.

2. **D.** Escheat is the authority of the government to take ownership of property of a deceased person who leaves no will, heirs, nor creditors. In most states, it reverts to the state. In some states, it reverts to the county in which the property is located.

3. **B.** Eminent domain is the government's constitutional power to appropriate private property for public use. The actual act of taking private property for public use is known as appropriation or condemnation.

4. **A.** To condemn K's property, even if for the public good, the government must give him just compensation.

5. **D.** While eminent domain is a constitutional government right, it is NOT a police power. Zoning, building codes, and environmental protection are all examples of the government's police power to make laws and regulations.

6. **A.** That is called a comprehensive or master plan.

7. **B.** Building codes set construction standards, and plans must comply with the code for a permit to be issued. Failure to comply with the permit may result in a stop order, fines, and/or injunctions.

8. **B.** Of these choices, a gas station is probably least likely to be granted a conditional use in a residential neighborhood, especially in a subdivision in the suburbs.

9. **A.** The zoning board can issue an area variance to reduce the setback and allow him room to build his ramp.

10. **C.** A nonconforming use occurs when land use does not conform to current zoning laws but is legally allowed because the land use was established before the new zoning laws were enacted.

11. **A.** Zoning ordinances usually regulate permitted uses of land, lot size, building size, and location, etc. The number of outlets in a room is more likely to be a building code requirement.

12. **B.** She can request a use variance, which would allow her to build her café in a residential area. She doesn’t have a nonconforming use exception since she hasn’t been using the land as a café. Spot zoning is illegal.

13. **C.** The doctrine of laches describes the loss of a right due to a failure or a delay in asserting that right, in this case, the right to enforce the deed restriction.

14. **D.** This is known as spot zoning, and it is generally illegal in most jurisdictions.
15. C. Deed restrictions in violation of fair housing laws, such as restrictions on the sale of the property to people of a particular race, religion, or creed, are void.


17. C. This disclosure is mandated for houses built prior to 1978, which is the year lead paint was discontinued.

18. B. Friable materials are dangerous when inhaled.

19. D. Liability for cleaning up contaminated property may be transferred to new owners unless the buyers investigate the property prior to entering into a contract. XYZ Inc. should perform its due diligence and hire a professional to conduct an environmental site assessment before making an offer.

20. B. There could be up to four phases to a CERCLA environmental site assessment. They are: I. Investigation, II. Testing, III. Remediation (cleanup), and IV. Management of the site.

Chapter 18: Closing Real Estate Transactions

1. C. RESPA applies only to one- to four-family residential properties (including condominiums and cooperatives) financed by a federally regulated loan.

2. D. Much of the closing is based on what is outlined in the purchase agreement.

3. B. The grantor, Seller C, is the only one who signs the deed.

4. A. A bill of sale transfers title of personal property.

5. C. The parties present are typically the buyer, seller, listing broker, lender, title company representative, and possibly attorneys for both sides. Roundtable closings are sometimes called face-to-face closings.

6. B. Under the provisions of RESPA, a lender must allow the borrower at least three business days to inspect the Closing Disclosure settlement statement.

7. D. Section 9 of RESPA prohibits a seller from requiring the homebuyer to use a particular title insurance company, either directly or indirectly, as a condition of sale. Buyers may sue a seller who violates this provision for an amount equal to three times all charges made for the title insurance.

8. A. There’s no implication that the arrangement between XYZ Title and ABC Brokerage includes any kickback for referrals. The other examples are clear violations of Section 8 of RESPA as they indicate some sort of “thing of value” in exchange for a referral.

9. B. Real estate brokers and mortgage companies may have an interest in each company so long as the real estate broker discloses its relationship with the joint venture company when it refers a customer to the mortgage broker or other settlement service provider.

10. A. An updated Closing Disclosure is required if the APR shown in the Loan Estimate increases by more than 1/8 of a percent for fixed-rate loans or 1/4 of a percent for adjustable loans. It triggers an additional three-day waiting period before closing.

11. C. The seller is responsible for ensuring that any existing liens are discharged.

12. A. These are expenses that are paid in arrears. A good example of an accrued item is ad valorem property taxes.

13. D. The sales commission is typically paid by the seller at closing and thus reduces his net from the sale of the property; it is a debit to the seller.

14. A. A new mortgage loan is a credit to the buyer, as it reduces the amount of money the buyer has to bring to the closing table. A new mortgage loan is neither a debit nor a credit to the seller.

15. D. The fee is paid every month, so there is no reason to prorate that fee when closing is on the last day of the month. It won’t appear on the settlement statement.

16. C. First, find the number of $1,000 units: $185,900 total ÷ $1,000 = 185.9 units. Round up to account for the fraction to get 186 units. If state transfer tax is 55 cents for every $1,000 unit: 186 units x $0.55 tax rate = $102.30. The seller owes the state $102.30 on the sale of the home.
17. **B.** First, calculate the cost per day ($3,390 ÷ 365 = $9.2876). Next, determine the number of days the seller lived in the house (January=31 + February=28 + March=31 + April=30 = 120). Finally, multiply the number of days the seller lived in the house by the daily tax rate (120 days x $9.2876 daily rate = $1,114.512). The seller is debited and the buyer is credited for $1,114.51 in taxes.

18. **B.** The daily rate is $2.1666 ($780 annual cost ÷ 360 days = 2.1666 daily rate). The seller lived in the house for eight months, leaving four months for which he paid but will not benefit, so 120 days. Multiply the daily rate by the number of days (2.1666 x 120) to find that the seller will see a credit of $259.99, and the buyer will see a debit of the same.

19. **D.** The seller used 75% of the fuel oil, so she's owed 25% of her cost: $820 total cost x 0.25 = $205 prorated cost. This would be a $205 credit to the seller and a $205 debit to the buyer.

20. **C.** To find the annual interest rate, multiply the loan amount by the interest rate ($315,000 x 0.05 = $15,750). Divide that by 360 to find the daily interest rate ($15,750 ÷ 360 = $43.75). Mortgage interest is paid in arrears. There are 14 days (April 17-30) for which interest is due, so multiply the daily interest rate by 14 days ($43.75 x 14 = $612.50). The buyer will be debited $612.50. This is only a debit to the buyer. This has no effect on the seller's side of the settlement statement.

**Chapter 19: Taxation and Investment**

1. **C.** Any maintenance expenses, such as a new roof, are not deductible on a primary residence. Mortgage interest, property taxes, interest on a home equity loan, casualty losses not covered by insurance, and in-home office use are deductible on a first and, sometimes, a second home.

2. **A.** They made a profit of $400,000 on the sale of the home. As a married couple, they qualify for $500,000 tax exclusion, so they will not owe capital gains taxes on the sale of that property.

3. **A.** An ad valorem tax refers to taxes based on the assessed value of property.

4. **C.** Special assessments are primarily used to pay for infrastructure costs for a specifically targeted project, often for a single street or neighborhood.

5. **D.** Multiply the assessor’s opinion of value by the statutory assessment ratio of 33% to find the assessed value of $83,325 ($250,000 x 0.3333 = $83,325).

6. **C.** A tax rate of 1.7% is equal to $1.70 per $100 of assessed value, $17.00 per $1,000 of assessed value, or 17 mills.

7. **B.** First, determine the assessed value: $250,000 x 0.40 = $100,000. Then divide by 1,000 to find the taxing units: $100,000 ÷ 1,000 = 100. Multiply that by the tax rate of $60 per $1,000 to find the annual tax: 60 x 100 = $6,000. To find the quarterly tax, divide by 4: $6,000 ÷ 4 = $1,500.

8. **C.** Use the tax formula; Percent (Tax Rate) = Part (Property Taxes) ÷ Whole (Assessed Value) and plug in the known values. $8,200 ÷ $148,900 = 0.0550. To find mills, move the decimal point three places to the right: 55 mills.

9. **B.** First, find the assessed value by dividing the taxes by the tax rate: $720 ÷ 0.018 = $40,000. Then divide the assessed value by the assessment ratio: $40,000 ÷ 0.50 = $80,000.

10. **B.** On a new home purchase, the owner’s equity is limited to the amount of the down payment. In this case, M made a 20% down payment: $300,000 x 0.20 = $60,000. He has $60,000 in equity in the home.

11. **D.** Remember “what he made divided by what he paid.” He made a profit of $9,900 ($37,200 + $37,200 = $74,400; $74,400 - $64,500 = $9,900). Therefore, $9,900 ÷ $64,500 = 0.153 or 15.3% profit.

12. **B.** Remember “what she lost divided by what it cost.” She lost $14,000 ($278,000 - $264,000), so $14,000 ÷ $278,000 = 0.05 or 5% loss.

13. **B.** The time requirement to depreciate residential rental property is 27 1/2 years.

14. **D.** Most real property can be exchanged for any other real property; similarly, personal property can be exchanged for other personal property. An exception is livestock of different sexes.

15. **B.** Leverage is the use of other people’s money to make money.
16. C. The purpose of a like-kind exchange is to defer capital gains taxes owed from the sale of one investment by exchanging that property for another like-kind investment property.

17. D. Depreciation is based on 55% of the $350,000 market value, or $192,500 ($350,000 x 0.55). Divide that by the recovery period of 39 years for non-residential rental property to find $4,935.89, rounded to $4,936 ($192,500 ÷ 39).

18. A. First, determine the potential gross income: $950 x 2 units x 12 months = $22,800. Determine the vacancy loss: $22,800 x 0.05 = $1,140. Find the effective gross income: $22,800 - $1,140 = $21,660. Find the net operating income: $21,660 - $4,200 = $17,460. Finally, use the IRV formula to find the cap rate: $17,460 (Income) ÷ $208,000 (Value) = 0.0839 (Rate) or 8.4%.

19. B. Cash flow is simply net operating income minus debt service: $28,000 - $15,600 = $12,400. The insurance and property taxes would have already been deducted from the effective gross income as operating expenses to arrive at the NOI.

20. B. Deduct annual debt service of $32,400 ($2,700 x 12) from the $35,000 net operating income to find a cash flow of $2,600. Divide that by his investment (acquisition cost) of $50,000 to find the cash-on-cash return of 5.2%: $2,600 ÷ $50,000 = 0.052.

Chapter 20: Professional Ethics

1. C. This is an example of culpable negligence, a misrepresentation, which while perhaps accidental, could nonetheless result in a lawsuit.

2. A. The broker can be held liable because his statements to the buyer were possibly fraudulent and could be looked upon as an inducement to enter into the purchase agreement.

3. C. An agent is not allowed to disclose confidential information about his seller clients. Keeping such information secret is not an example of fraud. The other activities could be.

4. C. Puffing is generally considered to be an opinion that is not necessarily intended to be a statement of fact. The use of an adjective such as “stunning” or “charming” is not necessarily puffing. Calling a street the “most prestigious in town,” however, would qualify as puffing.

5. D. The Code of Ethics does not address duties to real estate licensees in general, though it does address duties to other REALTORS®. This is in addition to duties to the public and to clients/consumers.

6. A. If the licensee intentionally leaves old listings posted, consumers could accuse her of using bait and switch tactics.

7. B. Antitrust laws were enacted to ensure that there are no restraints on trade.

8. A. Two or more licensees who conspire to divide their customers in any way are guilty of violating antitrust laws against allocation.

9. C. Commission can be negotiated between client and broker. All of these other phrases could get a real estate licensee into severe trouble. Antitrust laws must be taken very seriously.

10. C. G and his fellow brokers were guilty of illegal boycotting when they conspired to refuse to deal with another broker.

11. B. Even the appearance of discussing fees could be considered illegal price-fixing.

12. D. She is trying to tie in other business in exchange for taking the listing. This could be an antitrust violation.

13. D. A and B work for the same employing broker. There is no antitrust violation unless they worked for different employing brokers. If that were the case, this would be an example of illegal market allocation.

14. A. A blind ad is defined as any real estate advertisement placed by a licensee that does not include the listing broker’s business name. In most states, blind ads are prohibited.

15. B. This penalty was imposed by an administrative agency, the FTC, not the courts. Therefore, this is a cease and desist order, not injunctive relief. If a brokerage ignored the order, the FTC could ask the courts to step in and impose injunctive relief or stiffer penalties if appropriate.

16. D. A business may call a consumer with whom it has an established business relationship (EBR) for up to 18 months after the transaction, even if the consumer’s number is on the National Do Not Call Registry.
17. A. Internal customer DNC lists must be updated every 30 days.

18. C. Because they have an established business relationship, D has the option to call her for 18 months. If a consumer has asked to be put on a company’s internal do not call list, the company may not call to solicit new business, even if there is an EBR.

19. B. Once a request is made, it must be honored within 10 business days. Any opt-out mechanism must be able to process opt-out requests for at least 30 days after the message has been sent.

20. C. The federal Fair and Accurate Credit Transaction Act (usually referred to as the FACT Act or FACTA) includes provisions to protect the identity and personal information of consumers by requiring companies that handle such data to have policies to secure and destroy it.

Chapter 21: Property Management

1. A. The landlord and the property manager are the parties to a management agreement.

2. B. The property owner is the principal, the one to whom the property manager owes her fiduciary obligations.

3. D. A security deposit helps a landlord ensure compliance with a lease.

4. B. A property manager is a general agent authorized to handle all of the principal’s affairs in one area or in specified areas.

5. D. A property manager is a real estate licensee. In all likelihood, preparing an owner’s income tax returns is beyond the scope of authority granted to a property manager in the management agreement.

6. B. The management agreement between a property manager and a property owner creates an agency relationship.

7. C. Routine inspections are an example of preventive maintenance.

8. B. The ECOA prohibits discrimination based on source of income. The property manager would also have to comply with the ADA and the Fair Housing Act and not discriminate against the applicant because of his disability.

9. D. Licensees are obligated to obey only the legal directions of a client.

10. C. Reserves for replacement, also known as capital expenses, are funds set aside for projects such as roof repair or major systems replacements or upgrades.

11. D. Supply and demand plays a critical role when deciding fair market rent. As the number of available units increases, it may be necessary to lower rent. When occupancy rates are high, it may be possible to raise the rent.

12. B. The rent in the building may not be competitive if no one has moved in five years. It might be a good idea to raise the rent.

13. B. Property taxes and insurance are fixed expenses—ongoing operating expenses that do not vary based on occupancy levels of a property.

14. C. The property manager cannot discriminate on the basis of familial status, but he can limit the number of occupants in a unit. A two-bedroom unit may be limited to a total of four people, no matter who shares what room.

15. B. If a tenant files a complaint against the landlord, that is not grounds for eviction. The other situations may be.

16. D. In most states, the first step in the legal eviction process is to give the tenant written notice to quit. Generally, tenants have a statutory number of days to either make full payment or vacate the premises.

17. C. The landlord is trying to evict the tenant in retaliation for complaining about code violations. She will not be successful if this is her rationale for eviction since retaliatory eviction is illegal.

18. D. Privacy and the right of entry are part of the implied covenant of quiet enjoyment.

19. D. P has illegally bypassed the formal eviction process with this self-help eviction.

20. A. A forcible entry and detainer action is a lawsuit filed by a landlord to evict a defaulting tenant and regain possession of the property. It is the second step in the legal process of actual eviction.
Chapter 22: Introduction to Commercial Real Estate

1. B. Basic property law and contract law are the same for commercial property and residential property. The other statements are false.

2. C. Of these choices, a law firm would likely be an example of a typical Class A tenant. Remember, however, that the difference between office space classifications is relative. What is Class A space in one town may be Class B in another town.

3. A. Anchor stores, also referred to as magnet stores, are strategically located in shopping centers to generate traffic for smaller stores.

4. A. Environmental concerns are most often associated with industrial property.

5. C. To calculate the maximum size building for the site, take the total square footage of the parcel, which is 36,000 (300 x 120 = 36,000), and multiply it by the 20% floor area ratio (36,000 x 0.20 = 7,200).

6. C. A sale-and-leaseback arrangement is a method for financing commercial or industrial properties. In this situation, a company will construct a building that suits its needs, and then sell the building to an investor, who becomes the landlord.

7. D. Some investors may prefer single-family residential investment property because of the relatively smaller management requirements.

8. C. Demographics is a typical concern of investors considering an investment in retail property.

9. D. Topography would be a concern of investors considering an investment in undeveloped land.

10. D. With a net lease, the tenant pays all or part of the cost of ownership in addition to rent. In this case, F’s lease is a net-net-net lease, or triple net lease, since he’s paying all three costs.

11. B. A new owner will often ask current tenants to sign an estoppel certificate acknowledging their obligation to pay the agreed-upon rent according to the terms of their existing leases.

12. D. Net square footage refers to the space between the walls, the usable space.

13. B. The base rent is $30,000 ($15 x 2,000 square feet = $30,000). GEM has 20% of the office space (2,000 sq. ft / 10,000 sq. ft = 0.20), and so should pay that percentage of the annual maintenance ($10,000 maintenance x 0.20 = $2,000). GEM’s annual rent is $30,000 + $2,000, or $32,000.

14. C. First, to find a natural breakpoint, divide the annual base rent by the overage percentage ($12,000 ÷ 0.075 = $160,000). K did not exceed her breakpoint, so she pays only the base rent.

15. C. A percentage lease is typically associated with retail property.

16. C. First, find the rentable square footage: 4,000 USF x 1.08 = 4,320 RSF. Next, multiply the rentable square footage by the cost per square foot: 4,320 RSF x $6.85 = $29,592 in annual rent. Divide by 12 to find the monthly rent: $29,592 ÷ 12 = $2,466 in rent every month.

17. A. The building efficiency is found by dividing the usable square footage by the rentable square footage: 165,000 ÷ 180,000 = 0.916 or 91.6%.

18. A. A lease with an escalation clause requires the tenant to pay more rent to offset unanticipated expense increases.

19. D. If the usable square footage is 8,000 and the load factor is 1.08, the rentable square footage is 8,640 square feet. The commission is based on the rentable square footage, not the rent. At 80 cents per RSF, the commission is $6,912 ($0.80 x 8,640 = $6,912).

20. C. Many states have passed broker lien laws that allow commercial real estate brokers to file a lien against property to secure the payment of earned commission.

Chapter 23: Residential Construction and Home Inspection

1. A. Blueprints are detailed plans used to evaluate design, determine feasibility, and guide construction of a structure. Specifications are written documents describing in detail the requirements for the scope of construction, including materials, standards, and expected quality of the finished structure.
2. B. Electrical wiring must meet the standards set forth in building codes.

3. D. Slab-on-grade construction is a concrete foundation built directly on the ground. A slab-on-grade house does not have a basement.

4. B. In platform construction, a house or building is constructed one story at a time, with each story serving as a base for the next.

5. C. With a sloped joist roof, instead of rafters, joists go from the outer load-bearing walls to the pitch of the roof. Since there are no joists parallel to the floor, this construction allows for vaulted ceilings. Vaulted ceilings are not possible with ceiling joists and trusses. Balloon construction is a type of framing, not roofing.

6. C. A roof’s vertical rise in inches divided by its horizontal span in feet is its pitch. The pitch indicates the slope of the roof.

7. B. Rough-ins—such as plumbing, electrical wiring, and HVAC ducts—are installed as part of the interior finish work. Once installed, the rough-ins are hidden by drywall.

8. D. Electrical is not a basic structural component of a building. It is added after the basic structure is in place.

9. C. Framing is the load-bearing skeleton to which the walls and roof system are attached.

10. B. The common measurement of heating capacity is the British Thermal Unit, or BTU. It measures the amount of heat needed to raise the temperature of one pound of water by one degree Fahrenheit.

11. A. The underground base that supports a foundation is called a footer.

12. A. A gable roof has two planes of equal size that meet at the ridge. This is the most common type of roof.

13. C. Rough-ins are items hidden later by finished walls that are vital to the operation of the house.

14. B. Once construction is complete, a final inspection is conducted. If the structure complies with all relevant building codes, the jurisdiction issues a certificate of occupancy.

15. B. A Cape Cod is typically a small, symmetrical one-and-one-half-story home with a steep gable roof sloped to the front of the house.

16. B. Tudor homes are recognizable by the mixture of half timbers and stucco. These other characteristics are associated with contemporary homes.

17. C. Style refers to a distinctive appearance, which is defined by the principles of the architecture (e.g., Cape Cod, Colonial, Tudor, etc.). Split-level is a house design related to how the house functions.

18. B. A lower HERS rating means the house is more energy efficient. A rating of 60 means that the house is 40% more energy efficient than average.

19. A. For large electrical appliances, such as ranges, large air conditioners, large tools, and clothes dryers, the requirement is 220 volts.

20. D. The rate at which water moves through soil is called the percolation rate. Before installing a septic system, a percolation test, or perc test, must be performed to determine its feasibility.
PRACTICE EXAM

1. A. A bill of sale is used to transfer ownership of personal property. Chapter 2: Accounting for Personal Property.

2. C. An exclusive listing agreement is a bilateral contract. A client cannot just terminate the agreement before the term ends. Doing so constitutes a breach, which would likely obligate the seller to paying full commission on the sales price to the listing brokerage. Chapter 9: Revoking a Brokerage Agreement; Exclusive Right to Sell.

3. B. The Residential Lead-Based Paint Hazard Reduction Act requires real estate licensees, property management companies, sellers, and landlords to disclose known lead-based paint hazards for homes built before 1978. The other statements are true. Chapter 17: Lead; Required Lead Disclosure.

4. C. $96,000 - $84,000 = $12,000 loss. $12,000 (lost) ÷ $96,000 (cost) = 0.125 or 12.5% loss. Chapter 19: Calculating Profit and Loss.

5. A. The broker must disclose and present the seller with all offers to purchase the said home. It is a breach of the broker's fiduciary duties to withhold pertinent information such as multiple offers. Chapter 8: Duties of a Seller's Agent.

6. D. Steering is channeling prospective buyers or renters to or away from specific neighborhoods based on their race, religion, national origin, or other protected class to maintain or change the character of a neighborhood. When real estate licensees make assumptions about the types of neighborhood clients would like to live in instead of showing them all available options, they are practicing steering. Chapter 10: Steering.

7. B. Under the provisions of RESPA, a lender must allow the borrower at least three business days to inspect the Closing Disclosure settlement statement. Chapter 18: Preparing the Closing Disclosure.

8. A. When annual debt service is subtracted from the net operating income, any amount remaining would be considered the cash flow. Chapter 19: Cash Flow.

9. C. Market value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale. Chapter 15: Value.

10. D. The listing broker can be held liable because he has a duty to disclose material defects, especially when they are not easily discoverable. His statements to the buyer could be looked upon as an inducement to enter into the purchase agreement and could, therefore, be considered fraud. Chapter 8: Material Facts.

11. C. The lender will use the lesser of the sales price or the appraisal to consider how much it is willing to lend. In this case, the appraisal is lower. With a loan-to-value of 80%, the lender will loan $150,400 ($188,000 x 0.80). That means she must make a down payment of $39,100 to purchase this house: $189,500 (sales price) - $150,400 (loan amount) = $39,100 (down payment). Chapter 14: Loan-to-Value.

12. B. A real estate licensee is not obligated to disclose information regarding sex offenders in the vicinity, as this is considered immaterial to the condition of the property. Licensees should direct interested buyers to local law enforcement for the most up-to-date information about sexual offenders. Chapter 8: Megan’s Law.

13. C. Depreciation does not count the land value, but is based on 55% of value of the improvements, or $181,500 ($330,000 x 0.55). Divide that by the recovery period of 39 years for nonresidential rental property to find $4,653.8461, rounded to $4,654. Chapter 19: Statutory Recovery Period.

14. A. Ad valorem property taxes are paid first in the event of a foreclosure. Chapter 4: Lien Priority.

15. B. When someone dies without a will or without heirs, the property escheats back to the state. Chapter 17: Escheat.

16. D. A blind ad does not contain the name of the listing brokerage, which could lead a consumer to think it’s for sale by owner. Most states prohibit blind ads. Chapter 20: Blind Advertisements.
17. B. Of these statements, the only factual one is that FHA-insured loans require a lower down payment than conventional loans. The qualifying standards are a bit less stringent as well. The other statements are false, but represent a number of misconceptions about FHA financing. Chapter 14: FHA-Insured Loans.

18. C. When making adjustments, add the value of a missing feature to the value of the comparable property, and subtract the value of any extra feature from the comp. The comp sold for $260,000. Add $5,000 for the bedroom and $8,000 for the basement that the subject has but the comp does not. Then subtract $4,000 for the pool the comp has but the subject does not. The adjusted value for the comp is $269,000, which is then an estimate of the subject’s value. Chapter 16: Adjusting Comparable Sales.

19. C. Information about terms of the transaction is off limits to a dual agent. The other information can certainly be shared as part of a dual agent’s ministerial services to his clients. Chapter 8: Dual Agency.

20. D. The landlord can choose to make the renovations himself at his expense or at hers. He can insist that she make them herself and return the property to its original condition when her lease is up. He cannot, however, refuse to allow her to make these renovations. Chapter 10: Disability.

21. B. Those in attendance have actual notice that the title has transferred. Recording the deed in the public record provides constructive notice to the public. Title is a concept, not a document. Chapter 6: Constructive Notice.

22. D. The sales comparison approach relies on finding comparable properties, which can be quite challenging with special purpose properties. In such cases, the cost approach is likely to carry more weight. Chapter 16: Advantages and Disadvantages of the Three Appraisal Approaches.

23. B. Equitable title is a limited ownership interest in property created on the execution of a valid sales contract, whereby actual legal title will be transferred by deed at a future date, generally at the closing upon full performance of the contract. Chapter 12: Purpose of a Purchase Contract.

24. C. RESPA applies only to one- to four-family residential properties (including condominiums and cooperatives) financed by a federally regulated loan. Chapter 18: Real Estate Settlement Procedures Act (RESPA).

25. D. A corporation is a legal person. Therefore, a corporation owns property in severalty. Chapter 5: Corporations.

26. C. First, add all of the expenses to find the desired net after commission: $3,500 + $96,000 + $45,000 = $144,500. Then determine the amount of the sales price left after commission: 100% - 6.5% = 93.5% or 0.935. Finally, divide the desired net by the commission: $144,500 / .935 = $154,545.45. She must sell her home for at least $154,546 to get the desired seller’s net and pay the contracted commission and other expenses. Chapter 15: Using Seller’s Share to Determine List Price.

27. A. Condemnation is the act of taking land through the state’s power of eminent domain. Chapter 17: Eminent Domain.

28. C. In this relationship, the agent, S, exclusively represents the buyer. The seller is representing himself and is her customer. Chapter 8: What is Agency?.

29. D. This homeowner could likely get an area variance that would allow him to build a ramp even though it would violate the setback requirements for that property. Chapter 17: Area Variance.

30. C. Start with 640 acres per section and work back from the description of NE 1/2, SE 1/4: 640 ÷ 4 ÷ 2 = 80 Acres; 80 Acres x $5,000 = $400,000 Sale Price; $400,000 x 0.07 (Commission Rate) = $28,000 ÷ 2 (50/50 Split) = $14,000 Per Brokerage. Chapter 7: Calculating Acreage. Chapter 9: Calculating Commission.

31. A. Functional obsolescence is a problem with the design of the structure itself. A roof can be replaced relatively easily; it’s an example of physical deterioration. Chapter 16: Functional Obsolescence.

32. B. With an exclusive right to sell listing, the broker is entitled to commission regardless of who finds a seller during the listing period. Chapter 9: Exclusive Right to Sell.
33. C. A nonconforming use occurs when land use does not conform to current zoning laws, but is legally allowed because the land use was established before the new zoning laws were enacted. Chapter 17: Nonconforming Use.

34. B. First find the number of $500 units: $327,650 ÷ 500 = 655.3. You need to round up to 656 to account for the “fraction thereof.” The state portion is 50 cents for every unit, so the state transfer tax is $328 (656 x 0.50 = $328). Chapter 18: Transfer Tax.

35. D. Raising the reserve requirement tightens up the money supply. Increasing the discount rate results in banks raising the cost of money. Selling government securities, as part of the Fed's open market operations, removes money from the economy, which also tightens up supply. Chapter 13: Federal Reserve System.

36. D. $44,000 - $26,000 = $18,000 NOI. $18,000 ÷ 0.10 = $180,000. Debt service is not considered when finding NOI. Chapter 16: Deriving the Cap Rate: IRV.

37. B. A listing agent may purchase the property only after full disclosure to the seller that he is the buyer. Chapter 8: Interest.

38. C. If a person has been declared incompetent by a court (because of mental illness, intellectual or mental disability, or senility), any contract she enters into is considered void and unenforceable by either party. Chapter 11: Classifying Contracts; Contractual Capacity.

39. D. The principle of substitution says that an informed buyer would pay no more for the property than what the buyer would pay to obtain a similar one with the same benefits and utility. Chapter 15: Substitution.

40. C. The tenant installed the pizza oven for her business. It’s a trade fixture, and it’s her personal property. She would have to remove it when her lease is up, or she could sell the oven to the new owner, if they can agree to terms. Chapter 2: Trade Fixtures and Leasehold Improvements.

41. A. The word “exclusive” could imply an intention to exclude people who are members of certain protected classes, which would be a violation of fair housing laws. Chapter 10: Advertising Practices.

42. D. Zoning ordinances are laws that divide a city or county into different areas, or zones, for the purpose of setting forth permitted uses and activities under each zoning classification and specifying requirements for compliance. Chapter 17: Zoning.

43. B. The interest rate on an ARM can move up or down based on the movement of a specific index, a statistical report that is generally a reliable indicator of the approximate change in the cost of money. The index is something that neither the lender nor the borrower has any influence over. Chapter 13: Adjustable Rate Loans; Index and Margins.

44. A. An assignment is when one lessee transfers interest in leased property to another party for the remainder of the lease term. Under this arrangement, both the assignor and assignee share liability for the terms of the lease, although the original lessee is secondarily liable. Chapter 11: Assignment.

45. C. If the broker has a listing agreement with the seller, as well as a buyer agency agreement with the seller, and one licensee is designated to represent her in both transactions, the licensee is both a designated seller's agent and a designated buyer's agent. Chapter 8: Designated Agency.

46. D. When a seller offers a commission to any broker who finds a buyer, this could be a form of an open listing. The seller does not recognize any sort of exclusive agency. Chapter 9: Open Listing.

47. A. The front-end ratio for a conventional loan is 28%. The back-end ratio is 36%. Looking at the back end, or debt-to-income ratio: $4,200 (income) x 0.36, equals $1,512. She has total monthly debts of $550 ($350 + $120 + $80) that must be subtracted: $1,512 - $550 = $962. This is how much she has to spend each month for principal, interest, taxes, and insurance on a house. Chapter 14: Total Debt-to-Income Ratio.

48. C. A comparative market analysis, similar to the sales comparison approach, can include currently listed competing properties, recently sold properties, and recently expired listings. It is administrative in nature and can benefit a buyer or a seller. It cannot be used to determine value for a federally regulated loan. That requires a licensed appraiser performing a formal appraisal. Chapter 15: Comparative Market Analysis.
49. B. The appraiser’s first step is to define the problem, which involves identifying the intended users and the purpose of the appraisal. Chapter 15: Step 1: Problem Definition.

50. A. An acceleration clause gives the lender the right to declare the entire loan balance due immediately because of borrower default or for violation of other contract provisions. This is sometimes referred to as “calling the note.” Chapter 13: Clauses in Financing Instruments.

51. D. Unlike most other types of insurance, title insurance covers the policy holder for something that happened in the past, prior to when the policy was issued. Specifically, it insures against a defect in the title prior to when the owner took title to the property. Chapter 6: Title Insurance.

52. B. First, determine the cost of the improvement: 1,200 SF x $80 = $96,000. Then find the depreciation: $96,000 x 0.20 = $19,200. Then apply the formula for determining value using the cost approach: Replacement Cost - Accrued Depreciation + Site Value = Property Value. So the answer is: $96,000 - $19,200 + $48,000 = $124,800. Chapter 16: Cost Approach.

53. A. This is a latent, or hidden, defect. If the seller knows about it but does not disclose it, it’s possible that he could be held liable. Chapter 8: Materials Facts.

54. D. External obsolescence occurs when something outside the control of a property or its owner makes it less desirable. The factors causing the obsolescence may be economic, environmental, or due to location. Chapter 16: External Obsolescence.

55. B. When insulation material is friable, which means it is easily crumbled or becomes powdery when manipulated by hand, the asbestos can be inhaled and become trapped in lung tissue or the digestive tract. Chapter 17: Asbestos.

56. A. $200,000 (Sales Price) ÷ $25,000 (Gross Annual Income) = 8 GRM. Chapter 16: Deriving the Multiplier.

57. D. There was no meeting of the minds. Acceptance must not vary the terms of the offer. When the seller failed to accept the offer as submitted, he, in effect, rejected it, and it became void. Chapter 11: Mutual Agreement.

58. C. The metes and bounds system uses distance (metes) and direction (bounds) to describe the boundaries of a parcel of land, using fixed monuments, such as a feature of the land or a surveyor pin. Chapter 7: Metes and Bounds System.

59. A. First, determine the total commission: $462,000 x .065 = $30,030. ABC keeps 60% of that: $30,030 x 0.60 = $18,018. The licensee gets 45% of that: $18,018 x .45 = $8,108. Chapter 9: Calculating Commission; Commission to Cooperative Brokers.

60. B. Adverse possession is way to acquire title to someone else’s real property through open, continual, adverse, and hostile use. Chapter 6: Adverse Possession.

61. A. Judicial foreclosure on property under a mortgage loan generally requires advertising in a newspaper of a court-ordered sheriff’s sale of the property to repay the debts owed. Chapter 14: Judicial Foreclosure Sale.

62. B. A defeasance clause protects the rights of the borrower, removing the lien against the collateral property once the loan is repaid. Chapter 13: Clauses in Financing Instruments.

63. C. A quitclaim deed can be used to correct this break in the chain of title. A correction deed or a deed of confirmation might also be used. Chapter 6: Quitclaim Deeds; Cloud on the Title.

64. D. An investor can realize a greater return when using other people’s money to finance the purchase of income-producing property. Chapter 19: Leverage.

65. C. Making a recommendation is not an antitrust violation, unless the use of that service provider is a required condition of doing business. Chapter 20: Antitrust Phrases to Avoid.

66. B. The lender (mortgagee) wants to ensure that property taxes and insurance are paid on the property, so it requires the borrower (mortgagor) to add one-twelfth of the insurance premiums and taxes to the monthly mortgage payment amount. Chapter 14: Escrow Accounts.
67. D. A management agreement, also called a property management employee contract, is a written agreement that creates an agency relationship between the property owner/investor and the real estate broker/property manager. Chapter 1: Real Estate Property Management. Chapter 21: The Management Agreement.

68. C. A telemarketer or seller may call a consumer with whom it has an established business relationship (EBR) for up to 18 months after the consumer's last purchase, delivery, or payment, even if the consumer's number is on the National Do Not Call Registry. Chapter 20: Established Business Relationship.

69. A. The Equal Credit Opportunity Act, or ECOA, is a federal law that ensures that all consumers are given an equal chance to obtain credit. Most notable among the law's revisions is prohibiting the discrimination against a potential borrower on public assistance. Chapter 14: Equal Credit Opportunity Act.

70. D. The overage rent represents a percentage of the difference between a negotiated amount and actual gross sales. This is a percentage lease. Chapter 12: Types of Leases.

71. B. Familial status is a protected class under amendments to the federal Fair Housing Act. Chapter 10: Familial Status.

72. B. A package mortgage includes both real estate property and personal property. Personal property can include lawn mowers, boats, furniture, etc. These items are financed together with one contract. Chapter 13: Collateral Loans.

73. C. Most states require listing agreements to contain a definite termination date. The other items are negotiable, and a licensee must inform the consumer of that fact. Chapter 9: Term of the Contract.

74. B. This financial situation would be considered material, as it could derail the transaction; it must be disclosed immediately. Chapter 8: Material Facts.

75. C. He would pay $5,760 at closing. Discount points are paid on the mortgage amount where one point is equal to 1%. After you subtract the down payment from the sales price of the home, the loan amount is $192,000: $192,000 x 0.03 = $5,760. Chapter 14: Discount Points.

76. B. Since he put a condition on the property, he limited what could be done with the property. This is a fee simple defeasible estate, also called qualified fee. Chapter 3: Defeasible Fee Estates.

77. D. The grantor of a general warranty deed warrants the title against any and all defects that might have arisen before or during his period of ownership. Chapter 6: General Warranty Deed.

78. B. The death of the property owner does not terminate an estate for years. The property owner's heirs must honor the lease, and so must the tenant. Of course, the heirs and the tenant could mutually agree to terminate the lease. Chapter 3: Estate for Years.

79. C. First, divide the base of the triangle by 2 (380 feet ÷ 2 = 190 feet) then multiply by depth (190 feet x 410 feet = 77,900 square feet). Finally, you can divide that by the number of square feet in an acre: 77,900 SF ÷ 43,560 = 1.78 acres. Chapter 7: Area of a Triangle; Acres.

80. D. Even when the relationship ends, the duty to keep information confidential does not end. Chapter 8: Confidentiality.

81. B. When a buyer purchases property subject to an existing mortgage, the seller is still liable for that original mortgage. In the other situations, the seller is relieved of liability. Chapter 13: “Subject To” Financing.

82. C. A special agent, also called a limited agent, has limited authority to perform a specific task or conduct a specific transaction. This is generally a short-term relationship. Chapter 8: Agent Authority.

83. A. First, find the square footage: 12 feet x 18 feet = 216 square feet. Divide by 9 to find square yards: 216 ÷ 9 = 24. Now, multiply the square yards by $18.50 to find the cost: 24 x $18.50 = $444. Chapter 7: Area Measurement; Cubic Measurement.

84. C. Generally speaking, when a large number of people move into an area, available housing will be at a premium, which creates a seller's market. Chapter 1: Supply and Demand.
85. **B.** Joint tenancy includes the right of survivorship. When one joint tenant dies, that interest is automatically transferred to the remaining joint tenant(s). In this case, since C is the only remaining owner, C owns the property in severalty. Chapter 5: Joint Tenancy.

86. **C.** As the net operating income of a property increases, the value also increases. Chapter 16: Cap Rate and Risk.

87. **A.** When a licensee advises a buyer customer about an appropriate offer, he is providing a client-level service, not an administrative service. The other acts are clerical or informative in nature. Chapter 8: Transactional Brokerage.

88. **C.** A periodic tenancy is a type of leasehold estate between a landlord and a tenant. Chapter 3: Periodic Tenancy.

89. **C.** An encumbrance is a nonpossessory interest in someone's property, and is considered a burden. Chapter 4: Overview.

90. **B.** $50,000 x 0.12 = $6,000 annual interest. $6,000 ÷ 12 months = $500 interest for month one. $514.31 payment - $500 interest = $14.31 in principal. $50,000 - $14.31 = $49,985.69 balance after first payment. $49,985.69 x 0.12 = $5,998.32 annual interest. $5,998.28 ÷ 12 months = $499.86 interest for month two. $514.31 payment - $499.86 interest = $14.45 in principal. $49,985.69 - $14.45 = $49,971.24 balance after second payment. Chapter 13: Calculating Principal and Interest.

91. **A.** Places of worship, private clubs, and historical buildings are exempt; however, historical buildings must still comply with the “maximum extent feasible.” Although civil penalties may not be assessed in cases against state or local government, there is no exemption for these facilities. Chapter 10: Public Accommodations.

92. **A.** First calculate the cost per day ($3,450 taxes / 365 = $9.4520 daily rate). Next, determine the number of days the seller owned the property (January=31 + February=28 + 20 days in March = 79 days). Multiply the number of days by the daily tax rate to find the amount the seller owes: 79 x $9.4520 = $746.71. The seller is debited and the buyer is credited for $746.71 in property taxes. Chapter 18: Methods of Proration.

93. **B.** An option is a contract in which one party (the seller) gives another party (the buyer) the right to buy or lease his property at a specified price within a limited time, but without the obligation to do so. This means that option agreements are unilateral contracts that are binding only on the seller. Chapter 12: Options.

94. **D.** When using a deed of trust to finance the purchase of property, a disinterested third party trustee holds title to the property on behalf of the seller as security. The buyer has only equitable title until the loan is repaid. Chapter 13: Trust Deeds.

95. **C.** In order to comply with the statute of frauds, a lease must be in writing if it will last for more than one year. An oral lease for less than one year is generally enforceable. The other statements are false. Chapter 12: Leases.

96. **D.** The Jones v. Alfred H. Mayer Co. ruling upheld the Civil Rights Act of 1866, prohibiting any racially based discrimination, with no exceptions. Chapter 10: Significant Supreme Court Cases.

97. **B.** An agency relationship ends automatically if the broker or the client dies or becomes incapacitated, the broker or the client goes bankrupt, the property that is the subject of the agency is destroyed or condemned, or the broker loses his license. Chapter 8: Operation of Law.

98. **B.** A cooperative is a building owned by a corporation. Those living in the co-op are shareholders in the corporation. This is evidenced by a proprietary lease. Chapter 5: Cooperatives.

99. **C.** This is a three-part question. The first thing to do is calculate the assessed value: Percent (Assessment Ratio) x Whole (Market Value) = Part (Assessed Value), or 0.45 x $296,000 = $133,200. Next, complete the problem using the tax formula: Percent (Tax Rate) x Whole (Assessed Value) Part (Property Taxes). Insert the values known and calculate. 0.0052 x $133,200 = $692.64. The 5.2 mill tax levy will cost the property owner $692.64 annually. The levy will last for three years, so the total tax burden is $2,077.92 ($692.64 x 3). Chapter 19: Calculating Taxes.

100. **A.** A planning board will least likely be interested in specific building codes. The other factors, however, would be significant when considering a new subdivision. Chapter 17: Building Codes; Subdividing Land.
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